Responsible Investment's second decade:

Summary report of the state of ESG integration, policy and reporting

Discussion paper prepared for CalPERS Global Peer IESG Exchange, October 6, 2010

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Released August 15, 2011

Foreword

"CalPERS believes that environmental, social, and governance issues can affect the performance of investment portfolios to varying degrees across companies, sectors, regions, and asset classes over time." [1]

CalPERS commissioned this report from Mercer in early 2010 in order to survey the Responsible Investment landscape and identify leading practices around the world. The report provided a starting point for an interactive exchange with global peers on October 6, 2010, where CalPERS and others discussed leading practices and next steps for Responsible Investment. CalPERS is now releasing the report as we move forward with our plans to further integrate ESG factors into our investment strategies across asset classes.

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[1] CalPERS Global Principles of Accountable Corporate Governance

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Introduction

Responsible Investment's second decade

The Responsible Investment (RI) industry is a continually growing and changing field that encompasses institutional investors, asset managers and financial service providers. Since the launch of the UN Principles for Responsible Investment (PRI) in 2006, a number of innovations, initiatives and events have moved the industry significantly forward. The Principles now represent more than 800 signatories and over $20 trillion in assets under management.

The RI field has made progress on many fronts: tools for accessing information about environmental, social and corporate governance (ESG) issues are increasingly available, and publicly available data around corporate social responsibility (CSR) and sustainability practices is continually expanding; institutional investment strategies focusing on ESG-themed investments or integrating ESG factors into the investment decision-making process are common across many traditional and alternative asset classes; and, finally, research into the relationship between financial performance and ESG factors, both academic and applied, continues to improve in quantity and quality. In addition, public communication standards with regards to RI-related activities and RI reporting have increased significantly.

RI strategies at the forefront of the industry can be delineated into three themes: ESG integration, active ownership and targeted or thematic investing. Specific implementation approaches vary among investors, and within this report we will discuss common strategies and emerging practices. As the RI industry has evolved, these three approaches have each received a significant amount of attention. Active ownership, however, is the most prevalent RI activity, as the importance of proxy voting and monitoring corporate governance practices is typically considered to be a component of fiduciary duty within the mainstream financial community. Engagement activities have been continually increasing due to the emergence of international collaborative initiatives.

Investors' priorities regarding specific ESG issues

RI strategies and active ownership activities encompass a wide range of specific ESG issues, and views as to which sub-issues are most critical to a robust RI strategy, and how best to address those issues, vary. That being said, issues such as corporate governance, climate change, and human/labor rights are issues that are identified across the RI community as high profile and priority topics. Investors can focus on these issues in developing their RI strategy and engagement campaigns, and in directly addressing these issues in their portfolio holdings and investment strategy.

Corporate governance can entail a range of specific topics, but broadly it is an area that attracts a lot of attention from responsible investors and mainstream investors alike. As governance data and ratings have proliferated, pension organizations and asset managers have made some efforts to explicitly integrate corporate governance standards or to enhance the review of governance indicators in public equity portfolios. There are also investment strategies available that focus on improving the governance of a concentrated group of companies in order to increase shareholder return. However, by and large, corporate governance is most often addressed through shareholder voting and engagement activities, and increasingly through engagement in public policy debates.

Investors may have different rationales for assigning great importance to corporate governance. Corporate governance is often used to indicate management quality and management's overall treatment of shareholders. Corporate governance is also a way to look into the ethics of a company's management and operations. The predictive abilities of corporate governance are discussed later in the report, but it is fair to say that most investors, even those not active in RI, put some value in the assessment of governance in preventing scandals from breaking within the portfolio. Scandals relating to fraud (Enron, Madoff etc.) show that breaches of ethical norms can be intertwined with unforeseen investment risk. Larger investors may also see value in corporate governance as a macro issue: raising the bar across the market will decrease the occurrence of serious negative events and perhaps smooth volatility in the overall market over the long run.

Several groups, initiatives and approaches exist to address governance issues. The Council of Institutional Investors (CII) in the US and the International Corporate Governance Network (ICGN) provide a forum for advocacy and discussion of corporate governance and offer members services such as model voting policies and analysis of regulations. Investors may use these networks to help develop a common set of priorities, objectives and approaches relating to corporate governance. However, corporate governance priorities may also differ by geographic region. Investors may also develop different approaches to engaging on governance issues. One approach is to create a focus list of companies where the investor may devote more engagement resources to specific companies and issues. Other investors engage with portfolio companies either directly, through a collective initiative or campaign, or through a third party. Sometimes a combination of these methods is utilized.

Climate change is another priority issue common to investors interested in ESG issues. There are numerous investment strategies across asset classes that address this issue and investors are increasingly considering investment opportunities and risks associated with climate change. There is less standardization and agreement on how to evaluate a company's total exposure to, or impact on, climate change, however, and so approaches to integrating associated factors into portfolios vary. Investors may also link climate change to other issues such as water scarcity, health concerns, and corporate governance.

The most common method of approaching climate change is to use a combination of targeted investments (in public or private equity) and voting and engagement on climate change and related topics. As with governance, there are numerous groups pursuing research and advocacy in this area. Climate change is a top priority for Ceres and the affiliated Investor Network for Climate Risk (INCR) in the US, and the Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration of European Investors.

It is also increasingly common for investors to apply some consideration of climate change factors to their real estate investments. The potential for energy (and cost) reductions in this sector make it a logical place to take action regarding climate change. There is also a growing body of academic evidence to support the consideration of green building and energy efficiency in real estate allocations. This activity in real estate speaks to the trend of investors integrating ESG asset class by asset class and sector by sector rather than by ESG issue.

There are also social issues that are prominent among responsible investors. Human rights or labor rights are the most often discussed, and there are several specific issues that may be included under this umbrella such as child labor, supply chain issues, forced labor, and others. Social issues tend to be most often addressed via engagement and shareholder campaigns. However, a developing trend within the industry is to provide allocations to socially targeted or impact investments. Examples of these may be community development, microfinance, or social venture capital investments with market rate return expectations. These investments are still relatively uncommon, but are becoming more popular in certain geographic regions.

Relatively few pension organizations publically state their integration priorities in terms of specific ESG issues, but for the few that do, it is often a statement of engagement and active ownership priorities within public equity rather than priorities for integration across asset classes. This may reflect the earlier and, thus, more advanced development of RI within public equity as well as an interest among organizations in examining each asset class or investment to determine the most relevant ESG issues from an investment perspective and a mission or policy perspective.

RI and investment performance

Underlying the growth of RI is an increasing body of evidence that RI in its many forms can enhance investment value and/or mitigate risk. In October 2007, Mercer published Demystifying Responsible Investment Performance, a joint report with the Asset Management Working Group of the United Nations Environment Programme Finance Initiative (AMWG UNEP FI). In 2009, Mercer published a follow-up entitled Shedding Light on Responsible Investment: Approaches, Returns and Impacts. Both reports examined the link between ESG issues and financial performance through existing academic and broker research. Pooling results from the two reports, there are 36 studies in total: 20 studies showing evidence of a positive relationship between ESG factors and financial performance; 2 showing evidence of a neutral-positive relationship; 3 showing evidence of a negative-neutral relationship; 8 showing evidence of a neutral relationship; and 3 showing evidence of a negative relationship.[2] There are many other studies that examine specific asset classes and the impact of integrating ESG criteria. Individual studies are cited in Chapter 3, preceding the discussion of ESG integration across asset classes.

A majority of studies discussed in the two Mercer reports showed a positive link between ESG factors and performance, and new research continues to be released which supports this thesis. For long-term investors, the evidence increasingly shows merit in RI approaches practiced within the context of fiduciary duty. However there are several studies that show neutral or negative impacts of responsible investment.

In general, neutral studies conclude that ESG integration does not harm financial performance, or rather impacts it in a neutral fashion. For example, one such study finds that companies that are highly ranked with regard to socially responsible investment (SRI) criteria can have lower book-to-market ratios, but do not generate excess returns when tested in a linear regression model. [3]

Many of the negative studies (and a good deal of studies showing positive links as well) deal with socially screened portfolios. Mercer and others may view socially-screened or SRI portfolios as different from RI portfolios, as SRI portfolios screen out sectors or companies against certain "ethical" criteria which may or may not be related to an investment case. With SRI, generally, these criteria are first and foremost, whereas with

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[2] Shedding Light on Responsible Investment: Approaches, Returns, Impacts. Mercer Investment Consulting. November, 2009.

Demystifying Responsible Investment Performance, http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf. Mercer and AMWG UNEP FI. October, 2007.

See Chapter 3 for further discussion of academic and practitioner research.

[3] Galema R, Plantinga A, Scholtens B. The Stocks at Stake: Return and Risk in Socially Responsible Investment. Journal of Banking and Finance, 2008.

RI, the investment comes first with ESG issues being part of the research or decision-making.

However, SRI portfolios do make up a substantial part of the track record for consideration of ESG issues in a portfolio context, thus they are often used for academic research. There are many reasons for different types of investors to exclude companies and in the US and Norway, for example, there are government entities that may mandate such exclusions. Mercer believes that in many cases exclusions can also be managed to minimize any impact on performance, but attention must be paid to the amount of exclusions that result, if there are available substitution stocks and how and when stocks may be excluded.

With all of these caveats, the results of research on performance of ESG integration do vary and longer histories and more studies will continue to help the dialogue along. For example, Mercer described the following takeaways from the 2009 Shedding Light report:

- A variety of factors, such as manager skill, investment style and time period, are integral to how ESG factors translate into investment performance. It is not a "given" that taking ESG factors into account will have a uniform impact on portfolio performance.
- Research and the integration of ESG into investment processes need to be measured and conducted at the disaggregated level, as far as practicable.
- Finally, most of the studies to date focus on the link between ESG and listed equity investments, with little research on other asset classes. This is beginning to change, as we will see below.

The 2009 report did include studies on hedge funds and microfinance with favorable results in terms of the positive link. In addition, since the report has been published, more research has been released on ESG-related investments. However, the research to date does remain concentrated in three areas:

- Public equity: The largest body of research on ESG and performance uses Socially Responsible or Sustainability indices or criteria and compares the resulting portfolios to mainstream samples. The results are varied as one would expect given the number of possible combinations of ESG criteria, time periods, etc. However, most studies seem to show at least a neutral relationship between screening and performance over the long term.
- Corporate governance and shareholder activism: Many studies show a positive link between different types of activism or corporate governance measures and performance at the company, stock price, or portfolio level.
- Themed or ESG-targeted investments: As experience grows in this area, more track records of investment products and indices are available to show the performance and risk profile of these investments. While most is focused on public equity, recently there is more information to be found on alternatives such as "green" real estate, private equity and microfinance.

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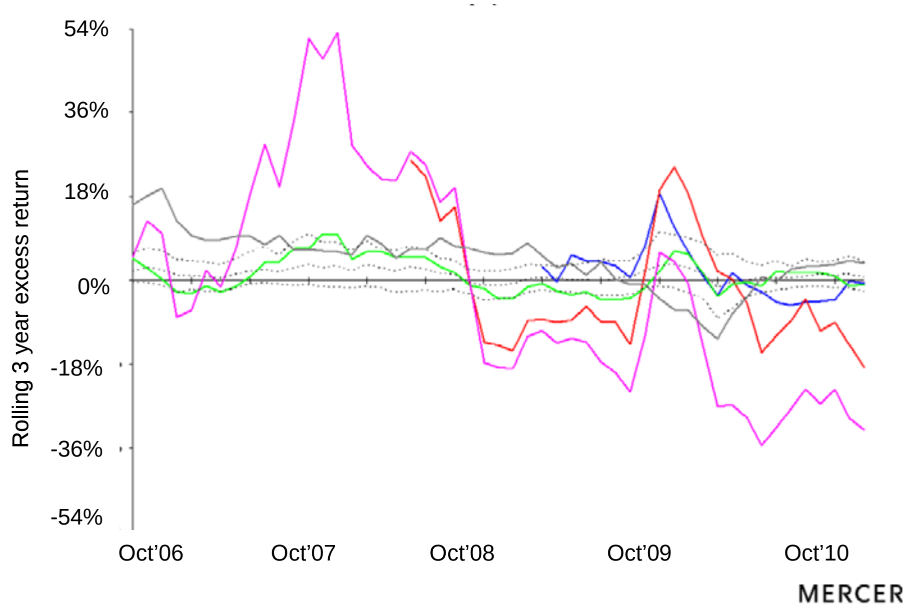
It is worth reiterating the fact that manager quality and skill may play as or more important a role than the approach to ESG issues in ultimate performance. RI is not a "one size fits all" approach that will always outperform or underperform, and it is not a single asset class where all investment options share similar characteristics. Even among those practicing RI there are many forms and approaches and many types of investment processes considering how it integrate ESG issues. Therefore, discussion of RI strategies as being certain to outperform or underperform is inaccurate. When considering the performance of a real portfolio that integrates ESG factors, investors in the field must consider the ESG strategy, but also investment manager quality and, most importantly, how the two fit together.

To illustrate these points we provide the table below, which shows the excess return from thematic ESG managers (managers that focus on specific ESG issues such as climate change, renewable energy or water) against the MSCI ACWI from 2006-2010.[4] The colored lines represent various thematic managers' excess return over the index, while the dotted lines represent the top quartile, median, and bottom quartile's excess return with regards to Mercer's Global Equity universe. The important aspect of this table is the difference in performance among the various managers, who are all investing in environmental themes. It is important to note that risk characteristics may also vary widely.

Thematic Equity Managers vs. MSCI World (Before Fees)
Excess Return in Global Equity from Oct 2006 to Dec 2010



MSCI World -- Manager A -- Manager B -- Manager C -- Manager D -- Manager E --

[4] Mercer Investment Consulting: Manager Performance Analytics. August, 2010.

The performance discussion around ESG integration is a nuanced one, requiring some understanding of how ESG issues can be applied to different asset classes and investment strategies. It is not assumed that a portfolio of companies or assets with the best ESG performance will always outperform. On the contrary, those companies may have certain characteristics (large companies with consumer brands in developed countries) that would lead to style biases and higher valuations at times. This would likely lead to periods of underperformance at times. The task before responsible investors is to uncover the nuances of where and how to apply ESG considerations to maximize long-term, risk-adjusted portfolio value.

As evidence mounts that ESG factors can materially impact financial performance, their consideration within the investment process is considered increasingly important in relation to fiduciary duty. As activities that integrate ESG factors within investment decision-making expand among asset owners, asset managers and service providers, we see an opportunity to take stock of different approaches. CalPERS commissioned this specific report from Mercer in order to respond to this opportunity and identified the scope and purpose of the report.

Purpose of this report

In order to assist investors in identifying common methods of implementing and disclosing RI strategies, this report uses a review of publicly available information to identify established practices, new themes and emerging ideas in:

- Implementing RI and ESG-related policies
- Public reporting on activities

This aggregation and comparison of publicly available information is designed to help financial organizations determine where they stand within the community of organizations that are implementing RI policies and where the community stands with regards to its goals and commitments. Further, readers can use this report to compare their publicly disclosed information on RI activities with the policies and practices in the broader industry. The information may also to help indentify gaps between implementation and disclosure regarding RI approaches, and identify areas for improvement.

Although many of the findings herein are at the total fund level, this project is particularly interested in how organizations are focusing on RI and ESG-related activities within individual asset classes. In discussing specific approaches within each asset class, we aim to identify repeatable and scalable models for ESG integration and public communication of progress. We also aim to spark follow up discussions about ideas for additional collaboration for ESG integration in specific asset classes.

In aggregate, the objective of this report is to assess the “state of play” of the RI industry for investment fiduciaries, and provide insight on the following:

- Areas of particular strength or weakness
- Areas where improved collaboration among peers and improved communication of objectives within a public forum could enhance market efficiencies

Methodology

The information in this report is presented at the aggregate level. Mercer gathered the information from a number of public resources, including organizations' websites, organizations' public reports, public responses to the PRI Reporting and Assessment survey, and other public resources and media sources. Although Mercer's experience in the RI industry informed and shaped the research process, we have not included any facts in this report which are not available in the public domain.

In order to determine the pool of applicable public information, Mercer used a broad selection of peers for comparison, consisting primarily of large public funds since information for these funds is most readily available. The peers represent large pension organizations around the globe that have made a public commitment to RI, whether it be through signing the PRI, through getting involved with other collaborative initiatives, or through publicly disclosing a RI policy and/or action plan. These include "single purpose" pension organizations, which represent one sponsor, or one group of members/beneficiaries, as well as broader pension investment organizations that represent multiple depositories or groups of beneficiaries. The peers also include a select number of investment managers recognized for their leadership in RI.

The topics covered in this report are based on the framework of a questionnaire that CalPERS distributed to a number of the organizations described above that are participating in a collaborative project designed to identify gaps in public reporting, opportunities for improved collaboration, and ideas for ESG integration across asset classes. All organizations participating in this project were included in the selection of peers reviewed for this report. In comparing this report with the confidential responses to the questionnaire and interviews, CalPERS will be better prepared to develop its approach to ESG integration within its overall investment program and reporting on RI activities, communicating with peer organizations along the way.

Report layout

The major sections of the report discuss elements and structures of responsible investment policies adopted by institutional investors (Chapter 2), how those policies are implemented within asset classes (Chapter 3) and how investors report on RI and ESG integration (Chapter 4). Each chapter reviews established practice in major categories of activities and commitments and highlights emerging practices, gaps in publicly available information and topics for discussion. Chapter 5 presents an overall summary and conclusions.

Throughout the report, tables summarize findings according to the sources and the peers reviewed. The tables present specific activities that relate to RI and indicate the frequency for which these activities are discussed in the public domain. These tables are based on a qualitative review of public information and examples, rather than a purely quantitative survey. Given the diversity of the peers and information sources, Mercer determined that qualitative presentation of this information would be more constructive and conducive to follow-up discussions. It is important to keep in mind that the information presented in the report and in these tables is only representative of available information on institutional investors publicly active in responsible investment. Therefore, actual activities related to RI may occur more frequently or be more sophisticated than publicly available information indicates.

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Policy frameworks

Given that ESG integration is in its early stages and is continually evolving, policy statements represent organizations' approaches to RI at a particular moment in time. Some policies may be slightly ahead of or behind what the organization has actually begun to evaluate or implement. Pension organizations, particularly public funds, face the desire and mandate to be transparent as well as the need to mitigate reputational risks. Keeping this in mind, policy statements must balance these objectives with the evolving nature of ESG integration. Policy statements, therefore, may be intentionally and appropriately general in order to allow flexible implementation as organizations confront unexpected external and internal challenges and opportunities.

In our review of policy statements, supporting documents and reference material, we found several characteristics that policies often share, including:

- References to the Principles for Responsible Investment (as well as other codes and conventions)
- Statements supporting ESG considerations as a positive contributor to long-term return and/or risk management
- Emphasis on role of corporate governance
- Emphasis on certain key issues or themes (such as climate change)
- Collaboration with other investors as a key part of the implementation strategy

Below we expand on common approaches, trends, and emerging practices.

Highlights of policy review

Responsible Investment guidelines

The majority of organizations reviewed have a stand-alone RI policy addressing ESG issues. These RI policies usually apply to the total fund, but may specify objectives for certain asset classes. Where organizations have stand-alone RI policies, the guiding

Investment Policy Statement does not usually include RI objectives. In contrast, some organizations do not provide the RI policy as a stand-alone document, but rather integrate the RI policy into the organization's guiding Investment Policy Statement.

In most cases, organizations have stand-alone corporate governance policies in addition to stand-alone RI policies or in additional to guiding Investment Policy Statements that integrate RI objectives. As discussed in the next sub-section, these corporate governance policies usually integrate proxy voting and corporate engagement guidelines.

RI policy documents generally contain some information on investment approaches to RI, which may touch on some or all of the following topics:

- Exclusionary screening
- ESG integration
- Thematic/targeted investments

Exclusionary screening policies, if relevant, are typically described in some detail in policy statements, making it clear what may be excluded and why. Definitions of the issues considered based on reputational or ethical concerns, as well as the circumstances under which divestment may be used as a last resort, can frame the organization's views and the context for RI. In cases where screening is mandated by regulation, organizations typically discuss their views on the utility of screening. Several funds explicitly state that their strategy is not to exclude investments based on ESG criteria, but rather to include investments in the portfolio that display exemplary ESG performance (positive screening) and to engage with companies in order to improve the fund's ESG performance. In most cases the RI policy includes an explicit reiteration of the overall goal of maximizing return within acceptable levels of risk.

Within RI policies, ESG integration and thematic investments are often discussed in the context of specific asset classes. Many organizations have allocated to, or created, ESG themed funds as an early step in RI implementation. Themed investments may be associated with asset classes and/or specific ESG issues, with private equity clean technology funds being a common example. Integration polices are also becoming increasingly asset class specific, where consensus is building around major issues that are relevant for each asset class (for example, a focus on energy efficiency within real estate investments).

Approaches to corporate governance

The most common approach to RI among investors is setting up an active proxy voting and corporate engagement program to address governance and ethical issues as well as environmental and social issues. Many organizations were active owners well before the launch of the PRI. However, the field of active ownership has advanced significantly with the increasing prevalence of collaborative initiatives and campaigns, ESG research providers, and engagement overlay services. In addition, corporate management teams are demonstrating an increased willingness to engage with investors on ESG-related issues (at least in certain regions and on particular issues).[5] Funds and fund managers active in the RI space almost universally agree that active ownership and corporate governance are important components of an effective responsible investment program.

These activities are most applicable within the public equity asset class, but as we will discuss in Chapter 3, engagement is occurring in multiple forums and increasingly across asset classes. Given the content of proxy statements and the issues that regularly come up for annual votes (director elections, executive compensation, etc.), corporate governance polices are usually connected to the proxy voting and engagement programs. Almost all organizations reviewed for this report have publicly available proxy voting guidelines or corporate governance principles that guide their activities in this area. Usually these policies are stand-alone statements/documents, but in some cases they are included as part of a broader RI policy. In a few cases, organizations provide a corporate governance policy in the absence of a more general RI policy.

It is increasingly common for organizations to identify specific focus areas in their proxy voting and engagement policies. The focus areas may be related to specific ESG issues, particular sectors, or companies with specific characteristics. Some organizations build focus lists for engagement based on their specific areas of interest. The organization maintaining the focus list may make extra efforts to attend the annual meetings of focus list companies or pursue one-on-one or collaborative engagement on particular areas.

Collaborative engagement activities often play an important role in the overall RI strategy. Pension organizations and asset managers clearly have an interest in consolidating their assets for larger impact and an opportunity to consolidate some of the costs and risks of active ownership. Direct fund to fund collaboration is gaining momentum, as are group initiatives and campaigns. Corporate governance organizations such as the International Corporate Governance Network, the European Corporate Governance Institute, and the Asian Corporate Governance Association (ICGN, ECGI, ACGA) and national associations such as the Council of Institutional Investors (CII) provide an excellent forum for like-minded investors to collaborate. There are also several engagement service providers that can consolidate assets and interests from multiple clients.

Several efforts are underway to make institutional investors' proxy voting policies more readily available to individual investors, in order to make it easier for them to participate in the voting process as informed investors. For example, in the US, initiatives such as Shareowners.org and MoxyVote.com exist for this purpose. Forums and organizations also exist for institutions to share experiences and opportunities for collaboration. For example, the PRI Engagement Clearinghouse acts as a central resource for signatories to post or seek out engagement opportunities. The Interfaith Center for Corporate Responsibility is a US based organization with advocacy and research agendas covering

[5] Global CEOs Want Investors to Act to Create Sustainability 'Tipping Point,' http://www.unpri.org/files/UNGCLS_final.pdf. June, 2010.

ESG issues. The membership is largely faith-based but secular institutions also participate in ICCR's work. Ceres has a large online presence, with information on collaborative initiatives, forums and participation in social networking sites.

International conventions

In addition to the Principles for Responsible Investment, responsible investors often use international conventions and codes to define priority ESG issues or to frame specific investment criteria. Frequently referenced examples include the UN Global Compact, the International Labour Organization Standards (ILO), the Convention on Cluster Munitions, the Global Sullivan Principles and the OECD Guidelines for Multinational Enterprises. Organizations use these codes within their RI policies for several reasons. The codes represent existing, established frameworks that align with the organizations' approach to RI and, presumably, are compatible with their investment beliefs. Secondly, they are easily accessible in the public domain and, given their international acceptance, can lend credibility to the overall RI policy. Finally, international conventions provide a standardized approach to a given topic, rather than funds drafting custom policies.

Investment manager procurement

Several organizations reviewed for this report reference ESG requirements within their policies for seeking out and appointing external investment managers, regardless of whether or not they are looking for ESG-targeted or RI-branded strategies. These policies reference the inclusion of RI or ESG-related questions in RFPs. These questions can focus on the manager's ability to adhere to the organization's existing RI policy, as well as more general questions on the managers' views on the materiality of ESG issues and their particular approach to integrating them in the investment process.

Fonds de réserve pour les retraites (FRR), for example, integrates ESG-related questions into both stages of its procurement process, regardless of the specific mandate. FRR applies varying weights to the answers it receives, depending on the evaluation criteria. In general, FRR evaluates the second, more detailed round of tenders according to the following criteria:

- The quality of the investment process, where most ESG-related issues are addressed (up to 45%)
- The quality of operations, risk controls, voting and reporting (up to 30%, of which 10 points are dedicated to voting issues)
- Management fees (up to 40%); for passive managers, where voting and reporting is particularly important, voting issues can potentially account for 10% of the global questionnaire (this means that in the case where all other scores are globally equal, the PRI/ESG score can be decisive) [6]

[6] Gregoire Badault, FRR. Best Practice for Asset Owners: Manager Selection and ESG. PRI Signatory Intranet. June, 2010.

Other organizations such as Ceres, Railway Pension Investments (Railpen) and New York City Retirement System have published lists of questions that investors can use to ask their existing or prospective managers about ESG. These questions and procurement in general are discussed further in the "externally managed assets" section of the public equity portion of Chapter 3.

Strategic asset allocation

Based on the information reviewed for this report, asset allocation decisions with regard to RI or ESG-related factors have been focused within asset classes (the decision to allocate part of the public equity portfolio, for example, to an ESG-targeted investment) rather than between them. Public documents describing allocation decisions within asset classes indicate that organizations have identified investment opportunities related to RI or have sought potential hedges against future ESG-related risks. Quantitative analysis and academic research on the investment impact of these risks is a relatively new focus for the RI community. However, as investors turn more attention to total fund ESG integration, asset allocation may have a bigger role in discussions.

Within the broad investment community, principles of diversification are well understood. Research into risk factors and their associated return drivers are contributing to the evolution of total fund investment strategies, with a great deal of emphasis on preparing portfolios for different investment environments. Discussions around the opportunities to integrate ESG in terms of total fund asset allocation have picked up steam in the wake of the global financial crisis. Organizations are increasingly interested in the qualitative modeling of asset allocation and in taking a closer look at the risk factors inherent in certain asset classes as a framework for diversification.[7] The Fonds de réserve pour les retraites (FRR), for example, has conducted its own internal study examining the impact of various ESG factors, particularly environmental factors, on its long-term investment policy and strategic asset allocation.[8] As another example, Mercer has launched a project with 14 partners from around the world, the Carbon Trust and IFC (a member of the World Bank Group) to study the impacts of climate change risk factors on asset allocation.[9] Results are not yet available, but a public report is scheduled for release in early 2011. Deutsche Bank Climate Change Advisors has also published a report entitled Investing in Climate Change 2010 - A Strategic Asset Allocation Perspective.[10]

This research, coupled with trends toward more global investing, opens doors to including ESG risks and investment strategies in the equation. As more research becomes available, what have traditionally been considered more long-term and more qualitative issues may be more widely considered within asset allocation.

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[7] Diversification: A Look at Risk Factors. Mercer Investment Consulting. May, 2010.

[8] The FRR and Responsible Investing: 2009, http://www.fondsdereserve.fr/IMG/pdf/FRR_GB_IR09_WEB.pdf

[9] Global Investors Collaborate on Innovative Climate Change Allocation Study, http://www.mercer.com/summary.htm?idContent=1374855. March, 2010.

[10] Investing in Climate Change 2010: A Strategic Asset Allocation Perspective, http://www.dbcca.com/dbcca/EN/_media/InvestingInClimateChange2010.pdf. DB Climate Change Advisors. January, 2010.

Summary of policy review

Overall, it is important to keep in mind that policy statements must balance the objective of transparency and the evolving nature of ESG activities. Some organizations integrate RI goals into their guiding Investment Policy Statement, but most provide a stand-alone RI and/or additional corporate governance policy instead. In other words, many in the community have a stand alone RI and/or corporate governance policy, but no reference to RI in the more general investment guidelines. Investors may find that this structure has benefits in terms of reviewing the policy and maintaining control and flexibility in a dynamic and emerging area. However, it may also highlight differences in how the policy applies to certain asset classes or investment activities. As approaches to ESG integration develop there may be room for policy structures to develop as well. A summary of common approaches is provided here:

Activity:	Frequency (Red: Low; Yellow: Medium; Green: High)
Policy	
Stand-alone RI policy statement	High
Corporate governance policy that includes proxy voting and engagement principles/guidelines	High
Collaboration with other investors highlighted as a part of the strategy	High
Highlighting of specific ESG issues or areas of focus within the RI policy	High
Reference to international conventions within policy statements	Medium
Integration of RI objectives into overall Investment Policy Statement (without a stand-alone RI document)	Low
Integration of RI objectives into the overall Investment Policy Statement (when stand-alone RI document exists)	Low
RI policies designed specifically for particular asset classes	Low
Stand-alone engagement policies	Low
Integration of ESG factors into total fund strategic asset allocation	Low

RI policy: Leading practices

Among the publicly available information reviewed for this report, there are some examples that stand out in terms of RI policies. Two examples are described below:

Organization	Activity
ABP (Netherlands)	ABP's total fund Statement of Investment Principles states that it takes non-financial factors including factors relating to environmental care, social responsibility and corporate governance into account in the investment process. Following from this, ABP discusses this integration in its total fund Strategic Investment Plan for 2007-2009.[11] This integration of ESG-related principles in main fund documents represents a leading practice.
Universities Superannuation Scheme (USS) (United Kingdom)	USS has a website-based RI policy ("RI Objectives and Strategy") that fulfills many of the functions discussed in this Chapter about RI policy. The policy applies to the total fund, includes a statement of RI beliefs, and links to its broader investment beliefs and objectives. USS' specialist RI team is also mentioned in the policy alongside a link to the team's composition and bios. [12] Within this policy, there is a section on implementation strategy and a link to the strategy document for 2007-2011, which broadly discusses the organization's approaches to ESG integration, voting and engagement, industry activities and public policy involvement, and, more specifically, identifies objectives, methods of implementation and expected results. This document also briefly describes USS' activities under each PRI principle.[13]

RI policy: Looking ahead

In reviewing publicly available information for this report, we have observed topics and trends in the development of RI policy that may indicate possible future directions and opportunities for investors. Based on these observations, Mercer highlights the following topics/proposals for consideration among RI industry leaders:

2.1 Regular review (every 1-2 years) of the RI policy in order to include evaluation of existing components and consideration of new issues, approaches and objectives

2.2 Asset class specific policies or guidelines that apply ongoing research regarding material ESG factors and outline expectations for portfolio managers and monitoring efforts (guidelines can be useful internal tools, since they are typically more flexible and applied in nature than policy documents)

2.3 Timelines or targets for ESG integration across asset classes and targeted ESG mandates (tracked by AUM-ESG or the development of new indicators such as ESG training hours, etc.)

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[11] ABP Investments: Strategic Investment Plan 2007-2009, http://www.abp.nl/abp/abp/images/Brochure%20Strategic%20Investment%20Plan%202007-2009%20doc.nr.26.1066.07_tcm108-46252.pdf

[12] USS: Objectives and Strategies, http://www.uss.co.uk/UssInvestments/Responsibleinvestment/RIObjectivesStrategy/Pages/default.aspx

[13] USS Ltd Responsible Investment Strategy 2007-2011, http://www.uss.co.uk/Documents/RI%20STRATEGY%202006%20_Public%20version_.pdf

2.4 Guidelines for engagement with existing and new external managers, including ESG specific language within RFPs and ESG-related monitoring and reporting requirements

3

ESG integration across asset classes

Overview

Across the field of RI, we see a clear trend towards developing models and tools for ESG integration across asset classes. These types of activities are taking many forms. Organizations are considering new ways to enhance, expand and utilize ESG due diligence on public companies as well as on bonds, private equity investments, real estate investments, and infrastructure projects. Leaders in RI also appear to be increasingly interested in new ways of estimating the external social and environmental impacts of RI and ESG integration. New methods and approaches to collaboration and engagement (with both companies and investment managers) continue to develop as well. All this is evolving against a backdrop of rapid innovation within the broader investment community, creating new opportunities and challenges for ESG integration in emerging and niche investment strategies.[14]

There is also a growing interest in evaluating ESG factors' impacts on portfolio performance and continuing to work on how to benchmark or measure the performance of ESG investments. Available data increasingly supports the consideration of ESG factors in investment decision-making across asset classes. More work is needed, but performance and risk research continues to be released. The following examples of recent research support the consideration of ESG factors across asset classes.

Research supporting ESG integration

Research within the private equity asset class is developing. Thus far, it has been focused on targeted investments such as clean technology and microfinance. Early results in these areas appear promising:

[14] PRI Report on Progress 2009: A review of Signatories Progress and Guidance on Implementation, http://www.unpri.org/files/PRI%20Report%20on%20Progress%2009.pdf . 2009.

- For example, a 2010 report by JP Morgan Global Research stated that most microfinance institutions (MFIs) weathered the downturn fairly well. In addition, the research found that most MFIs "continue to maintain solid reserve and capitalization levels, with equity ratios unchanged from the 18-20% range established over the past two years." Additionally, to the authors' surprise, microfinance equity valuations globally have continued to rise – to a level that represents a 62% increase since 2007.[15]

- With regards to cleantech private equity, Deutsche Bank Climate Change Advisors reported some interesting findings their 2010 report, Investing in Climate Change 2010: A Strategic Asset Allocation Perspective. The report cites recent studies by New Energy Finance and the Cleantech Group, which have shown internal rates of return for the clean energy industry in excess of target returns for generalist private equity funds over the past three and five years. However, these data were marked-to-market before the recent downturn and heavily influenced by a few successful IPO's and buyouts. The report also points out that there have been outsized realized returns in the clean tech VC/PE space through IPO exits and M&A buy-outs.[16]

Regarding property, the research has largely focused on environmental issues and the investment premium or energy/water savings associated with "green" or sustainable real estate. Some of the more widely cited examples include the following:

- A 2008 McGraw-Hill Construction/US Green Building Council survey found markets for green commercial and institutional buildings in the US have risen from 2% in 2005 ($3 billion) to about 10% to 12% of construction value ($24-$29 billion) in 2008, with projected growth to 20% to 25% ($56-$70 billion) by 2013.[17]
- Current research by RREEF, Deutsche Bank's Real Estate division, reveals a shortage of energy efficient real estate to meet this growing demand. Price and value premiums observed for green buildings reflect this shortage of such properties on the market.[18]
- A Maastrict University study found an actual rental premium of 3.5% on US office properties, a 6% increase in occupancy for ENERGY STAR buildings (similar to

[15] O'Donohoe, Nick and Xavier Reille. All Eyes on Microfinance Asset Quality: Microfinance Global Valuation Survey 2010, http://www.jpmorgan.com/pages/jpmorgan/investbk/research/mfi. JP Morgan Global Research. March, 2010.

[16] Investing in Climate Change 2010: A Strategic Asset Allocation Perspective, http://www.dbcca.com/dbcca/EN/investment-research/investment_research_2253.jsp. DB Climate Change Advisors. January, 2010.

[17] Commercial & Institutional Green Building: Green Trends Driving Market Change. McGraw-Hill Construction and the US Green Building Council. 2008.

[18] Globalization and Global Trends in Green Real Estate Investment. RREEF Research. September, 2008.

McGraw-Hill survey results), and a 16% to 17% premium on transaction prices (sales price per square foot).[19]

- In a 2008 study, University of Arizona Professor Gary Pivo and Indiana University Professor Jeffrey Fischer found higher income and income growth, lower capitalization rates, higher net operating income per square foot, higher market value, higher rent and lower expenses for ENERGY STAR rated properties, compared to properties with no energy efficiency rating.[20]
- In a 2009 study, researchers at the School of Real Estate and Planning at Henley Business School found commercial building price premiums of 10% and 31%, respectively, for ENERGY STAR and LEED-certified buildings.[21]

The industry is also beginning to see more research on ESG issues applied to fixed income investing, specifically corporate credit. The primary contention of this research is that ESG concerns at a company can result in higher lending rates or lower bond ratings. Thus far, papers have been published with respect to environmental, corporate governance and social issues (human capital practices). The studies reviewed found that poor corporate performance in these areas adversely affects corporate borrowing, and/or, conversely, that there were positive attributes associated with favorable performance in these areas.[22]

There is a longer history of evidence and research regarding public equity. There is strong evidence that some ESG factors are linked to financial performance and performance records of investment managers and indices that support this. More recently, there has been additional focus on the areas of ESG integration and thematic investing in particular is an area where mainstream investment managers are paying closer attention and looking at the bigger picture with ESG issues as part of the story.

Alliance Bernstein produced a paper in 2010 that made the argument that thematic investing could enhance the global equity portfolios of large investors. The paper discussed the climate change theme as one possible approach, but provided evidence that thematic portfolios can outperform the broad market and that active management in these themes could outperform indices.[23] Mercer has conducted its own analysis (as yet unpublished) also showing that thematic environmental indices can outperform broad

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[19] Nils Kok. Maastricht University. PRI Workshop. January, 2009.

[20] Pivo & Fischer. Investment Returns from Responsible Property Investments: Energy Efficient, Transit-oriented and Urban Regeneration Office Properties in the US from 1998-2007. October, 2008.

[21] Franz Fuerst and Patrick McAllister. Green Noise or Green Value? Measuring the Price Effects of Environmental Certification in Commercial Buildings. School of Real Estate and Planning, Henley Business School. April, 2009.

[22] Bauer, Rob and and Daniel Hann. Corporate Environmental Management and Credit Risk. Maastricht University: European Centre for Corporate Engagement (ECCE). June, 2010.
Reviews by Robert Kropp. RI Digest Published by the PRI Academic Network. April, 2010.

[23] Profiting from Disruption: The Case for Thematic Investment. Alliance Bernstein. April, 2010.

market benchmarks with favorable reward/risk ratios. The table below illustrates the performance of environmental themed indices. [24]

Public market performance of climate change sectors	From Market Bottom**	1 Year	3 Year
MSCI World	69.7%	27.0%	-7.1%
Global Clean Energy / Technology*	87.9%	15.0%	39.7%
Global Energy Efficiency*	125.6%	70.7%	87.2%
Global Agribusiness*	77.3%	63.6%	103.6%
Global Water*	73.6%	28.2%	15.9%

With regards to corporate governance as one ESG factor to consider for integration, the Corporate Library published a 2009 study which constructed three hypothetical portfolios benchmarked to the Russell 1000. The portfolios were screened using the Corporate Library's governance ratings. The highest level of outperformance for one of the three portfolios —275 annualized basis points—was found for the portfolio applying the strictest governance screens. 121 basis points of the annualized outperformance for this portfolio were stock-specific, according to the attribution analysis they performed. In addition, approximately 74 additional basis points resulted from application of ratings being applied to each company on an absolute basis, rather than a sector neutral basis.[25]

Studies on the impacts of engagement have also shown a positive link between ESG and performance. Wilshire Associates has performed analysis of the results of CalPERS' Focus List initiative for several years. The most recent study concluded that, "from 1987-2008 companies targeted by CalPERS underperformed prior to CalPERS engagement by more than 30% annualized in the 5 years prior. During the five years after the 'average targeted company' outperformed by 2.4% annualized." [26]

Furthermore, Mercer has witnessed more "mainstream" investment managers exploring the opportunity that ESG integration presents. Two studies in particular highlight this trend and both conclude that there is potential value in ESG integration. Quotient Investors summarized their findings, focusing on the utility sector and the links between ESG reporting, ESG rankings and performance. The results were not consistent across

[24] Bloomberg, CRB Research, DBCCA analysis. 2010.

** Market bottom refers to 2009 low of MSCI World on March 9, 2009

* WilderHill New Energy Global Innovation Index (NEX), CRB Research Energy Efficiency Index,

DAXglobal Agribusiness Index, S&P Global Water Index

[25] Kimberly Gladman, CFA, Ph.D.,The Corporate Library's Governance Ratings and Equity Returns. The Corporate Library. 2009.

[26] Wilshire Associates Intl. The CalPERS Effect on Targeted Company Share Price. July, 2010.

all quartiles, but, in general, higher ranked companies did outperform their lower ranked peers.[27]

Another manager, New Amsterdam Partners, completed a broader study on the impact of different ESG factors, focusing on Return on Equity (ROE). Overall, the study found that ESG scores "have a predictive and positive association with subsequent total stock returns and financial performance measured by ROE, and this result holds even after controlling for the sector effect." The results were different among different ESG factors and the authors also found a stronger impact in mid- and small-cap stocks. [28]

In terms of other investments, several studies have found that hedge fund activism can improve investment performance of the underlying companies. A 2008 study, for example, found that hedge fund activism between 1998 and 2005 improved financial performance of underlying firms: firms that were targeted by hedge funds for active purposes earned larger excess returns and improvements in Return on Assets than firms targeted by the same hedge funds for passive purposes. [29] Additional research in the hedge fund space supports this view that hedge fund activism can create value for shareholders by influencing governance, but also suggests that "hostile" events, such as the sale of the target firm tend to generate higher returns than friendly events such as changes to capital structure or governance. [30]

Research will no doubt continue to be released into the market as more organizations experiment with RI and more investment managers and academic institutions undertake studies. So far, there is a strong case for incorporating ESG into investment decision-making. However, it will likely be up to the RI leaders to determine the optimum approaches for long-term investors across asset classes.

Activities across asset classes

Due to the dynamic nature of this field, publicly available information on fund activities is often limited to topics that are well established in the RI industry (public equity activities, for example). There are however, some items that have been showing up more recently in announcements or public RI materials, that are still rare, but encouraging in terms of furthering the development of ESG integration. These include integration of ESG

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[27] Andre Bertolotti, CFA. ESG Guidelines and Alpha: Can You Have Both? Quotient Investors. June, 2009.

[28] Clayman, Michelle and Indrani De. Are All Components of ESG Scores Equally Important? The Finance Professionals' Post. July, 2010.

[29] Clifford, Christopher. Value Creation or Destruction? Hedge Funds as Shareholder Activists. Journal of Corporate Finance. September, 2008.

[30] Alon Brav, Wei Jiang, Frank Partnoyc, and Randall Thomas. Hedge Fund Activism, Corporate Governance, and Firm Performance. Working Paper. 2006.

Alon Brav, Wei Jiang, Hyunseob Kim. Hedge Fund ActivismL A Review. Foundations and Trends in Finance. February, 2010.

questions into the procurement process across asset classes and studies looking into the impact of particular ESG issues on strategic asset allocation. Current practice or approaches that we frequently encountered in our review include:

- Targeted/themed investments in select asset classes
- Active ownership being applied to public equity and variations applied to other asset classes
- ESG or RI specialists working alongside asset class specialists to facilitate ESG integration
- Alignment of select ESG issues (climate change, human rights) with asset classes or sectors having evident exposure to those issues
- ESG reporting requirements for external investment managers

The following sections provide descriptions on integration activities with asset classes that are both established and evolving. The end of each section identifies some emerging practices as potential discussion topics.

Private equity

Highlights of ESG integration practices

A few aspects of this asset class that potentially align private equity with RI are the structure of most private equity funds and the legal partnership structure of the investment relationship. General Partners (GPs) can maintain their large stakes in companies for periods of 5 years or more while occupying a seat on the board or having a direct line of communication to management. This type of relationship, plus the relatively small number of Limited Partners (LPs) in a private equity fund, lends itself to opportunities for robust engagement on ESG issues, inclusion of ESG-targeted investments within the mandate, and integration of ESG factors into portfolio procedures beyond targeting ESG-specific companies.

These opportunities are starting to play out in the industry, with several pension organizations working closely with their external private equity managers to invest in clean technology projects, such as renewable energy production, and/or to integrate ESG factors into the due diligence and monitoring across various mandates. Some pension organizations are now requiring their private equity managers to include reporting on ESG issues in their regular communications.

Targeted investments

To date, the most common approach to applying RI principles to private equity has been to assign an allocation to ESG-targeted investments, most often in clean technology. This allocation is often a relatively small carve-out of the total private markets portfolio. Several private equity asset managers have developed products that focus on clean technologies in response to this growing demand. Global products of this nature often include investments in emerging market companies. There are also an increasing number of products that focus on a themed or RI approach to private equity in emerging markets in Asia based on that region's potential economic growth, population growth, and resulting infrastructure and resource needs.

At the same time, non-ESG-targeted private equity managers may include some clean technology investments in their portfolio as the market in this area continues to grow and develop. As the discourse around climate change and related ESG issues has developed, the definition of clean technology has also become broader and now includes a more diversified range of sectors, products and services (for example, utilities, water treatment, renewable energy, waste management) making it more plausible that large asset owners have exposure to clean technology in mandates that are not ESG-targeted. In addition to clean technology, a handful of investors have taken advantage of the emergence of private equity vehicles emerging in microfinance.

Several characteristics of private equity make targeted ESG-investments a logical, early approach to ESG integration in this asset class. Private equity is inherently a long-term investment strategy and based on emerging companies, technologies and sectors with growth expectations. In our view, the best private equity managers often have superior industry expertise and personal and professional networks. Having this edge is also beneficial for clean technology investing as the best in class technologies and related regulations are constantly in flux. Recent fluctuations in oil prices, government stimulus programs aimed at alternative energy development, and general attitudes towards the importance of renewable energy, have resulted in clean technology becoming a "sector of choice." This is true not only for large investors with RI commitments and private equity mandates, but also for many mainstream investors with a belief that the transition to a low-carbon economy will provide long-term investment opportunities.

While new institutional investors are continuing to enter this space and we expect this trend to continue in the future, we have only observed a small number of the pension organizations with existing ESG-targeted mandates or policies that publicly announce an increase in the total value of their allocations in recent years. We do not believe this is unique to the clean technology space, as private equity as a broad asset class is still adjusting to the recent recession. Among the small sample of organizations that have announced new allocations, some organizations have sought out and increased allocations to microfinance investments within private equity structures. It is interesting to note that this expansion of microfinance investments occurred during 2009, despite the pressure that the microfinance sector came under during that time.

One additional example of ESG-targeted investments within private equity is economically targeted investments (ETI). These investments typically attempt to provide social benefits locally— often the creation of jobs coupled with housing or services. Pension organizations allocate to these investments in order to gain investment returns while helping to grow the local tax base and thereby supporting the salaries of public employees. Given these ancillary benefits, these investments may sometimes offer a below market rate of return. A select few pension funds have made allocations to ETI programs that seek to invest in traditionally underserved economic markets. The Republic of South Africa Government Employees Pension Fund's Isibaya program and

CalPERS' California Initiative are two such examples. The Isibaya program invests in emerging sectors of the South African economy, including renewable energy and township business parks, while the California initiative invests in companies in California and elsewhere that have historically had limited access to capital, employ workers living in economically disadvantaged areas and provide employment opportunities to women and minority entrepreneurs and managers. [31]

Industry collaboration

In 2007, the PRI established a formal Private Equity Work Stream to act as a resource in developing ESG integration within the asset class. [32] The work stream's Steering Committee contributed to the development of the US Private Equity Council's (PEC) Guidelines for Responsible Investment, which were released in February 2009 and include suggestions for how Limited and General Partners can integrate ESG factors into private equity investments via due diligence, monitoring, engagement and increased transparency. [33] The PRI Private Equity Work Stream has thus far produced two documents, one outlining principles for integration within the asset class and the other providing case studies of Limited and General Partners implementing the PRI. Mercer included this case study report in its review of publicly available information regarding ESG integration.[34]

A more recent forum for industry collaboration that displays some overlap with the PRI is the International Limited Partners Association (ILPA). Launched in September 2009, 135 organizations now endorse the ILPA's Private Equity Principles, which promotes governance standards as a foundation for relationships between Limited and General Partners.[35] A large number of signatories to the PRI have also endorsed the ILPA Principles.[36]

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[31] Government Employees Pension Fund Responsible Investment Implementation: Integrating ESG Issues in Investments, http://www.gepf.gov.za/Investments/Documents/ESG%20Issues%20in%20Investment.pdf. June, 2009.

CalPERS California Initiative 2009: Creating Opportunities in Underserved Markets, http://www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/ca-initiative-09.pdf. February, 2010.

[32] PRI Private Equity Work Stream, http://www.unpri.org/privateequity/

[33] Private Equity Council Members Adopt Guidelines for Responsible Investment, http://www.unglobalcompact.org/newsandevents/news_archives/2009_02_10.html. February, 2009.

[34] Responsible Investment in Private Equity: Case Studies, http://www.unpri.org/files/PrivateEquityCS151209H.pdf. December, 2009.

[35] ILPA Marks One Year Anniversary of Private Equity Principles, http://ilpa.org/wp-content/uploads/2009/09/Principles-Anniversary-Final.pdf. September, 2010.

ILPA Private Equity Principles, http://ilpa.org/wp-content/uploads/2009/12/ILPA-Private-Equity-Principles.pdf. 2009.

[36] ILPA Update Newsletter Special Feature: Trends in Responsible Investment in Private Equity. http://www.unpri.org/files/ILPA_RI%20article_Winter%20Newsletter_Dec09.pdf. December, 2009.

In 2010, the PRI co-hosted a forum with the ILPA exploring best practices for ESG integration and how these can add value to private equity portfolios. Furthermore, the ILPA is currently pursuing discussions with the PRI regarding integrating ESG factors into the ILPA principles.[37]

Private equity: Summary of activities

Investment opportunities within this broad category are quite varied, but most ESG targeted allocations to date have been to clean technology/energy. In addition, asset managers and pension organizations have collaborated to establish guiding principles for this specific asset class, which will assist organizations as they consider how to approach RI in the context of this asset class in the future. Asset managers and asset owners have pointed out that private equity firms in Europe seem to be more receptive to RI guidelines than their US counterparts, while private equity firms in emerging markets are surprisingly receptive to the concept of RI. A summary of approaches to ESG integration in private equity is provided here:

Activity	Frequency (Red: Low; Yellow: medium; Green: High)
Private equity	
Allocations to ESG-targeted mandates through clean technology investments	High
LPs working with external managers to promote ESG integration	High
Participation in industry efforts to increase scale of ESG integration	High
LPs integrating ESG factors into the procurement process for new investments	Medium
LPs requiring external managers to periodically report on ESG integration	Medium
Policy statement with criteria specifically about private equity	Low

Private equity: Leading practices

Among the publicly available information reviewed for this report, some organizations stand out in terms of their private equity activities relative to their peers. Two examples are provided below:

[37] Private Equity Barbarians at the Gate of ESG: Conference Report, http://www.responsible-investor.com/home/article/pei_conference_report_barbarians_at_the_gate_of_esg/. June, 2010.

Organization	Activity
APG (Netherlands)	In 2009, APG made targeted investments within private equity beyond clean technology investment. The organization made an allocation to the Investment Fund for Health in Africa, which invests in private healthcare companies in Sub-Saharan Africa. In its 2009 Responsible Investment Report, APG notes that the fund allows it to help "improve and increase access to healthcare in Africa." APG also made an allocation to the Grassroots Global Microfinance Equity Fund, which invests in microfinance institutions around the world.[38]
New Zealand Superannuation Fund (New Zealand)	During 2009, while considering making a second investment with Direct Capital, New Zealand Super expanded its due diligence process to include RI criteria. Upon deciding to invest, New Zealand Super integrated RI standards into the mandate. Following this success, the Fund sought to refine its RI guidelines for all private equity investments, including the following: ▪ Inclusion of RI guidelines in due diligence during GP selection ▪ Investigation into previous investments to determine if the GP has previously integrated ESG considerations into the investment process ▪ Request that GP reports on material ESG issues as they arise [39]

Private equity: Looking ahead

Among the organizations that are integrating ESG factors into investment management processes in this asset class, there are activities that stand out as examples that seem likely to drive integration in the future. Based on these observations, Mercer highlights the following topics/proposals for consideration among RI industry leaders:

3.1 LPs engaging current GPs on ESG issues and encouraging GPs to integrate ESG factors into the due diligence process

3.2 LPs encouraging or requiring current GPs to report on ESG integration and incorporating it into their selection and monitoring processes

3.3 LPs seeding ESG-targeted private equity funds or fund managers

3.4 Collaborative industry efforts to improve the scale and capacity of ESG-related private equity investments, as well as metrics and standards for investment due diligence

3.5 ESG-targeted allocations beyond clean technology to other environmental and social ESG related sectors, as well as emerging markets

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[38] APG Responsible Investment Report 2009, http://www.apg.nl/apgsite/pages/images/40.0802.10%20APG%20Responsible%20Investment%20Report%202009_tcm124-109870.pdf

[39] New Zealand Superannuation Fund Responsible Investment in Practice Report, http://www.nzsuperfund.co.nz/files/Responsible%20Investment%20in%20Practice%20Report%20-%20%20July%202009.pdf. June, 2009.

Property

Highlights of ESG integration practices

Within this asset class, organizations have generally reached a consensus that benefits associated within environmental factors can add value to asset management. Academic and real estate industry practitioner research broadly supports the thesis that under certain conditions, there is an investment premium associated with "greener" assets. While the evidence points to this premium at the asset level, proof of the premium at the portfolio level has been more elusive, underscoring the importance of further research and public disclosure regarding implementation of environmental programs in the public domain.

Like private equity, the long term aspects and common structures of real estate investing lend themselves to ESG integration, as well as engagement with intermediaries (including tenants). Given that buildings are huge contributors to total carbon emissions, focusing on energy and resource efficiency improvements is a logical step for responsible investors.[40]

Responsible property programs

Pensions

Among the peers reviewed for this report, there are several pension organizations that have a specific policy document that guides RI activities in the real estate asset class. Some of these organizations have specific committees and/or programs in place to manage the implementation of these specific RI policies for real estate.

The main focus of these real estate activities is to ensure that ESG considerations (environmental considerations, especially) are included in the due diligence and ongoing monitoring processes for external investment managers and/or direct investments. At the broadest level, the programs describe ESG criteria that should be reviewed before investments are funded and, in addition, monitor the performance of real estate investments against expectations and internal targets or policies.

On a more specific level, some real estate programs include social considerations through the development of "responsible contractor policies" that encourage fair labor practices around construction and maintenance of real estate assets, or more specifically, the provision of "fair" wages and benefits to contractors and subcontractors. Responsible contractor policies are common among US pension funds, including CalPERS, CalSTRS, New York State Common Retirement System, Ohio Public Employees and the Illinois State Board of Investment.[41] Some organizations further

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[40] Energy Efficiency and Real Estate: Opportunities for Investors, http://www.ceres.org/Document.Doc?id=517. December, 2009.

[41] Laborers' International Union of North America: RCP and Union Labor Practices, http://www.liuna.org/SitePanelbar/ContactUs/CorporateAffairs/RCPandUnionLaborPolicies.aspx

integrate social factors into their real estate investments by advocating for activities that benefit building tenants. CalPERS, for example, recently adopted a policy that prevents it from investing in projects that will eliminate rent-controlled apartments and convert them to market rates.[42]

Specific targets or key performance indicators associated with the implementation of ESG-related real estate policies are not often publicly disclosed. For some investors, this information is proprietary. For others, this lack of disclosure could be due to the fact that organizations would need to establish specific quantitative milestones for the various categories and sub-sectors within the property asset class. Included in the due diligence and monitoring of real estate investments may be a level of engagement with various intermediaries to ensure or improve ESG integration. Some organizations have developed “responsible contractor” agreements that encourage fair labor practices around construction and maintenance of real estate assets. Tenants have also been engaged in the form of educational initiatives or “green lease” agreements which embed environmental requirements into the tenant’s use of a building.

Asset managers

There are a number of asset managers that have dedicated programs for Responsible Property Investment (RPI), which explicitly expand the ESG considerations beyond environmental concerns, to a range of social and economic issues. The objectives of these programs are more specific than those for pension organizations, since they often refer to specific investment strategies rather than a diversified portfolio. Although asset managers do not often disclose details about the environmental performance of portfolios, they often announce certain milestones or case studies. For managers engaged in these activities, internal and external tools are used to measure progress and performance. Proprietary criteria may be established for new developments and external frameworks such as LEED in the US may also be utilized.

Strategies within managers’ RPI programs address several different ESG issues including energy efficiency, water use and an increasing range of social and economic issues.

Environmental focus within broader real estate portfolios

Many of the organizations reviewed for this report identify energy efficiency, water consumption and waste management as particularly important environmental factors for this asset class. Although the measurement and benchmarking of the environmental performance of diversified and externally managed real estate portfolios is in its early stages, several organizations have initiated programs to develop environmental criteria, track environmental performance and monitor progress towards achieving portfolio-wide goals. Several asset managers have developed tools to assess which properties will

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[42] CalPERS’ Board Approves Policy Shift to Protect Rent Control, http://www.businessweek.com/news/2010-04-19/calpers-board-approves-policy-shift-to-protect-rent-control.html. Business Week. April, 2010.

yield the highest paybacks from energy efficiency improvements. These activities are generally applicable to the total real estate portfolio.

A different baseline activity can involve pre-investment engagement with external investment managers. Before investing in real estate strategies, some organizations gauge fund managers' willingness and ability to consider environmental issues, keeping in mind their own standards and assessing whether the manager will be able to adopt these standards as well. After investing, the organization continues this process by having the manager include environmental issues in its regular reports on the investments in the portfolio.

Responsible investors continue to support research on reasons and methods to consider environmental factors in real estate investing. Surveys of real estate investment managers and studies of the performance of green real estate assets can help formulate priorities and next steps for investors, and act as a baseline for current activities and results.

Industry collaboration

Given the challenges and opportunities associated with ESG integration within real estate portfolios, initiatives to promote ESG integration in the asset class have developed. The UN Environment Programme Finance Initiative Property Working Group is a prolific example of an initiative geared towards ESG integration in institutional real estate investing. The Working Group has many aims, but its overarching purpose is to "encourage sustainability in property finance." The PRI Secretariat has worked with the Working Group to more specifically align its Principles with property investing and, in 2008, published "Building Responsible Property Portfolios" as a result.[43] The Working Group itself has produced reports and a toolkit series on performance measurement, disclosure and engagement. The PRI also continues to work with the group as part of its Property Work Stream.

The Initiative for Responsible Investment at Harvard University hosts the Responsible Property Investing Center (RPIC). The Center serves as a clearinghouse for research, announcements and developments in the industry. The RPIC is primarily a US based group of investors, consultants, researchers and real estate organizations. Through these groups, investors have been able to discuss issue priorities and collaborate on projects such as discussing guidelines for assessing RPI credentials of indirect real estate investments and surveying real estate investors on RPI issues.

Property: Summary of activities in ESG integration

The diverse nature of real estate portfolios and the variety of intermediaries involved with property management makes this asset class a particular challenge. However, the direct

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[43] Building Responsible Property Portfolios: A Review of Current Practice by UNEP FI and PRI Signatories, http://www.unpri.org/property/PWG%20PRI%20report_final.pdf. 2008.

impact of environmental factors such as energy and water use on the bottom line means that some asset owners and managers have embraced policies for this level of integration relatively quickly. For the organizations reviewed for this report, the following represents a summary of RI-related activities:

Activity:	Frequency (Red: Low; Yellow: Medium; Green: High)
Real estate	
Specific mention of real estate within the stand-alone Responsible Investment policy statement	High
Assignment of specialists or specific committee to monitor application of the RI policy for real estate	Medium
Incorporation of ESG factors into the external manager due diligence and selection process	Medium
Requirement for external real estate managers to report on the environmental performance (energy and water consumption, emissions) of the portfolio	Medium
Implementation of benchmarking activities and energy efficiency improvements in direct property holdings and/or organization's office space	Medium

Property: Leading practices

Among the publicly available information reviewed for this report, some organizations stand out in terms of their ESG integration activities related to property. Three examples are provided below:

Organization	Activity
BT Pension Scheme (BTPS) (United Kingdom)	BTPS owns Hermes Fund Managers, which manages approximately 50% of the Pension Scheme. Based on information in BTPS' 2010 PRI Reporting and Assessment survey, it appears that Hermes Real Estate (HREIM) manages the full portfolio of investments in this asset class. Through HREIM, BTPS' total property portfolio engages in the following leading practices: ▪ Use of a proprietary Responsible Property Investment cost and benefit analysis tool to assess current holdings and determine priorities for improvement ▪ Provision of a "good performance" bonus for property managers that implement Responsible Property Investment measures ▪ Requirement for development and refurbishment teams to meet minimum Responsible Property Development standards ▪ Participation in external ESG and Responsible Property Investment benchmarking tool development [44]
PREVI (Brazil)	PREVI's entire property portfolio is managed externally. PREVI's Code of Corporate Governance Best Practices for Real Estate guides these investments and encourages the following activities for the improvement of properties' internal controls: ▪ Compliance with ISO 14001 and LEED standards ▪ Implementation of energy and resource use efficiency activities ▪ Adaptation of building facilities in order to guarantee accessibility to people with special needs ▪ Use of civil, electronic and hydraulic engineering expertise to improve existing properties [45]
New York City Public Pension Funds (United States)	The various pension funds finance multifamily buildings in the five boroughs of New York City via "forward commitments to provide permanent, long-term mortgages for the rehabilitation of new construction of multifamily buildings that will remain affordable for the long term."[46]

[44] BTPS, PRI Reporting and Assessment Survey 2010, http://www.unpri.org/report10/2010_PDFs/PRI%202010%20-%20Full%20Responses%20for%20publication%20-%20BT%20Pension%20Scheme%20(0017000000N7cuN).pdf

[45] PREVI, PRI Reporting and Assessment Survey 2010, http://www.unpri.org/report10/2010_PDFs/More/PRI_2010_-_Full_Responses_for_publication_-_PREVI_-_Caixa_de_Previdencia_dos_Funcionarios_do_Banco_do_Brasil_(0017000000N7czW).pdf

[46] Office of New York City Comptroller John C. Liu: Economically Targeted Investments, http://www.comptroller.nyc.gov/bureaus/bam/eti.shtm

Organization	Activity
TIAA-CREF (United States)	The TIAA General Account and the CREF Social Choice Account, via the Corporate Social Real Estate Program, funds investments in affordable housing, urban and transit-oriented commercial development and sustainable development.[47] Furthermore, property investments across TIAA-CREF are involved with the following leading practices: ▪ Establishment of a firm-wide goal to reduce energy intensity across all the office buildings in its real estate portfolio by 10% between 2007 and 2010 ▪ Mandate that all new development projects seek LEED certification [48]

Property: Looking ahead

In reviewing publicly available information for this report, we have observed topics and trends in the development of property practices that may indicate the future direction of the industry – especially as research, benchmarking of existing buildings and implementation of RI strategies in this asset class become more common. Based on these observations, Mercer highlights the following topics for consideration among RI industry leaders:

3.6 Development of real estate specific RI policies

3.7 Extension of ESG issues beyond energy efficiency, resource efficiency and waste management, including labor conditions

3.8 Incorporation of ESG factors into the due diligence and manager selection process for all real estate investments

3.9 Integration of ESG considerations into the management of direct property holdings

3.10 Requirement of LEED or other relevant certification for new development projects and for organizations' operational office buildings

3.11 Expansion of the range of investment vehicles available to responsible property investors through seed capital or engagement

3.12 ESG themed property-related investments such as green mortgages, affordable green housing bonds and energy efficiency funds (for example, financing energy efficiency retrofits and receiving the energy savings as returns, which could be a good opportunity for generating returns and providing catalyst funding)

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[47] TIAA-CREF Socially Responsible Investing: Community Investing, http://www.tiaa-cref.org/public/about/how-we-invest/sri/community-investing/

[48] TIAA-CREF and Environmental Investing, http://www.tiaa- cref.org/public/about/news/articles/gen0911_1932.html

Infrastructure

Highlights of ESG integration practices

Similar to private equity and property investments, infrastructure investments have long investment horizons that align them with several ESG issues. However, infrastructure is a relatively new asset class for many investors and generally has a more developed history in Australia and Europe than in other regions. Along these lines, ESG integration is a new activity in this space and is still in the early stages of expansion. That being said, the universe of infrastructure investments and the possibilities for ESG integration are great given the need for large scale infrastructure development in developing countries and the need for large replacements and updates around the world. The opportunities for ESG integration will be in part fueled by government stimulus packages around the world which are emphasizing renewable energy and alternative forms of infrastructure development.

Mercer generally finds that the lines between infrastructure and private equity investments can sometimes be blurred, particularly when investors focus on specific sub-sectors, such as renewable energy projects.[49] With regards to ESG-targeted investments, this may also be due to varying definitions of asset classes used by funds and the dynamic characteristics of project finance for green initiatives.

Targeted investments

Similar to private equity investments, the most common approach to applying RI principles to infrastructure has been assigning an allocation to ESG-targeted investments, most often in clean technology, or, more specifically, renewable energy. This allocation is often a relatively small carve-out of the total infrastructure portfolio. When making targeted investments in this asset class, organizations primarily focus on environmental issues including climate change, renewable energy, and water management.

A select number of asset managers have launched “green” infrastructure funds in recent years, although it is difficult to tell how much capital has been deployed to these funds. Local municipalities or regional development banks have created opportunities in renewable energy and water management projects that these fund managers can invest in. “Green” infrastructure investments often have geographic areas of focus or concentrate on particular issues in emerging markets. At the same time, Mercer has witnessed a growing number of non-ESG-targeted infrastructure managers include some renewable energy products their portfolios. Renewable energy (including hydroelectric power), waste management, and water are not unusual infrastructure investments for mainstream portfolio managers. As the market for carbon develops around the world investors may find more carbon finance projects or carbon hedging vehicles appearing in mainstream infrastructure portfolios as well.

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[49] Perspectives on Alternative Investments: Observations and Strategies for 2010 and Beyond. Mercer Investment Consulting. September, 2010.

Economically targeted investments, discussed within the private equity section above, may also involve infrastructure development. Some organizations have allocated to infrastructure mandates that target specific developing regions of the world. The Republic of South Africa Government Employees Pension Fund's Isibaya Fund, for example, invests in assets that "drive capital in a manner that the GEPF believes can marry investment returns with socioeconomic outcomes." The GEPF has allocated to the Pan-African Infrastructure Development Fund, which invests in projects throughout Africa.[50]

Due diligence and engagement

Global pension organizations and asset managers are increasingly acknowledging that environmental management of infrastructure projects and labor practices for projects are important factors to consider in the investment decision-making process. Some pension organizations have initiated the process of researching the possible impact and/or relevance of various ESG factors on sub-sectors of the infrastructure asset class. Other pension organizations have collaborated with their external infrastructure managers to develop policies for integrating ESG factors into investment decisions.

Aside from making targeted investments in this asset class, the most common RI activity for pension organizations is to integrate environmental and social issues into the external manager due diligence process and follow up with monitoring ESG integration practices on a regular, usually annual, basis.

Collaborative engagement initiatives within the infrastructure asset class specifically are relatively uncommon. Infrastructure investing by definition deals significantly with issues such as water, energy, and waste management. These issues are also common topics of research, engagement and collaboration in other asset classes as well. As more investors gain exposure to the asset class and apply RI experience and knowledge within infrastructure investing, there will be many opportunities for increased collaboration among organizations to improve the environmental and social performance of their investments. Opportunities for collaboration within the infrastructure asset class are especially applicable, since investors often co-invest, alongside asset managers and/or other investors.

Infrastructure: Summary of activities in ESG integration

Infrastructure is still a relatively new asset class for some investors. Investors may come to find that the ESG and investment characteristics of some infrastructure investments offer an opportunity to gain exposure to certain ESG-related sectors that are less attractive in other asset classes. For example an infrastructure investment in certain

[50] Government Employees Pension Fund Responsible Investment Implementation: Integrating ESG Issues in Investments, http://www.gepf.gov.za/Investments/Documents/ESG%20Issues%20in%20Investment.pdf. June, 2009.

emerging markets may have international sponsors and investors that make it more appealing than public equity or fixed income investments in that same market.

As organizations devote resources to assessing which ESG factors are relevant to this asset class, how to integrate them, and which managers share these views and capabilities, ESG integration in this asset class will become more widespread. While ESG-targeted investments are the most common form of RI activity in this asset class, there are a relatively small amount of organizations that are allocating to these vehicles. A summary of RI-related activities is provided here:

Activity	Frequency (Red: Low; Yellow: Medium; Green: High)
Infrastructure	
ESG policy that applies to infrastructure	High
Initiation of annual reviews regarding managers' ESG integration	Medium
Initiation of themed mandates, including clean technology and microfinance	Medium
Identification of material ESG factors for various types of infrastructure investments	Medium
Integration of environmental and social issues into the manager due diligence process	Medium
Collaboration with external managers to develop policies on ESG integration	Medium
Collaboration with co-investors to promote ESG integration	Low

Infrastructure: Leading practices

Among the publicly available information reviewed for this report, some organizations stand out in terms of their ESG integration activities related to infrastructure. Two examples are provided below:

Organization	Activity
Fonds de réserve pour les retraites (FRR) (France)	When the FRR adjusted its strategic asset allocation and began investing in infrastructure in 2009, it launched a preliminary analysis of ESG issues related to the asset class. Based on its analysis, the FRR built an ESG-questionnaire that it submitted to possible managers in the asset class and incorporated their responses into the due-diligence process. For the managers it did end up selecting, the FRR asked managers to produce regular reports on their ESG integration efforts. [51]
PGGM (Netherlands)	During 2009, PGGM examined this asset class and developed an ESG framework that identifies relevant ESG factors in 4 different sub-sectors: gas storage; toll roads; distribution networks for gas, water and electricity; and power plants. In 2010, PGGM will examine how it can apply these ESG frameworks to the investment process in the infrastructure asset class.[52]

Infrastructure: Looking ahead

Based on the information regarding infrastructure available in the public domain, particular topics and trends stand out as being especially relevant to the future development of ESG integration within this asset class. For this reason, Mercer highlights the following topics for consideration among RI industry leaders:

3.13 Increased industry collaboration as more investors consider ESG factors in their infrastructure investment decision-making processes
3.14 Increased collaboration of co-investors in order to promote ESG integration
3.15 Development of innovative ESG-themed infrastructure vehicles, perhaps including elements of other asset classes such as carbon finance
3.16 More research and case studies regarding social issues in infrastructure such as labor, human rights, health, etc.
3.17 Identification of innovative opportunities involving third party sponsors of infrastructure projects (such as the World Bank), and/or around specific themes (such as climate change adaptation)

Fixed income

Highlights of ESG integration practices

Progress is being made with regards to ESG integration in fixed income, but the asset class does present specific challenges. The opportunities for investors to engage with debt issuers can be more limited than in other asset classes. However, while many debt issuers are not publicly listed, there may be opportunities to engage with issuers at the time of issue. Dialogues with credit rating agencies have also begun and those organizations are increasingly to be found at RI events and forums of discussion.

[51] The FRR and Responsible Investing: 2009, http://www.fondsdereserve.fr/IMG/pdf/FRR_GB_IR09_WEB.pdf

[52] PGGM Responsible Investment Annual Report 2009, http://www.pggm.nl//Images/10-3538%20PGGM%20VB%20Jaarverslag%20UK-02-LoRes_tcm21-165939.pdf

Organizations do tend to apply any exclusionary policies focused on business activities to fixed income investments within the corporate credit allocation. Less frequently, there are also exclusions for sovereign debt based on a particular government's activities. There are also a select few pension organizations that utilize a variety of ESG criteria to proactively evaluate debt issues and have integrated this evaluation into their fixed income processes.

While ESG integration into fixed income is less mature than other asset classes, activity is starting to increase in this space. Research exploring the relationship between ESG factors and credit ratings continues, and innovation in targeted ESG investing within fixed income is becoming more prevalent. ESG integration within fixed income is likely to expand quickly beyond exclusionary screening.

Research relating to performance impacts of ESG and fixed income investments is still in early stages. Most performance track records of substantial length include negatively screened bond funds. In the US, those funds have generally underperformed the mainstream benchmark. However, with new ESG-related bond issuers coming forward and with asset owners, managers, ESG research providers, index providers, and ratings agencies paying more attention to fixed income, this is likely to change quickly.

Screening and ESG analysis

Within this asset class, exclusions of corporate securities based on ESG performance criteria, as well as exclusions of sovereign securities based on ESG criteria, are the most common approach to implementing the RI policy. Organizations may exclude sovereign debt only, corporate credit only, or both from the investment portfolio based on ESG criteria. In most cases organizations describe their rationale for screening securities based on ESG criteria in terms of risk management. Successful fixed income portfolio management relies heavily on avoiding securities that may experience sharp decreases in value due to default or ratings downgrades. Recovering losses at an overall portfolio level after significant decreases in bond value is difficult, since opportunities for upside gains are less common, relative to public equity for example. Hence, ESG screening may remain a preferred approach to fixed income, applied to ethical/reputational issues and other significant business risks.[53]

In many cases, organizations identify suitable exclusionary criteria based on international conventions or based on sanctions from international organizations. For example, conventions on banned weapons and UN Security Council sanctions influence several organizations' exclusionary criteria.

In the area of sovereign debt, a select few organizations make use of country rankings based on ESG criteria including Transparency International's Corruption Perceptions Index. These country rankings include both developed and emerging markets. These

[53] Responsible Investment and Fixed Income. Mercer Investment Consulting. September, 2009.

country rankings were not necessarily designed to assess investment risk; however, in combination with traditional credit ratings and analysis, these rankings can provide additional information on factors related to a country's willingness to pay. Investors may use an internal RI team to gather data and determine how these rankings might impact willingness to pay.

It is interesting to note that many mainstream sovereign debt managers that do not offer ESG-branded products employ some sort of governance screen or related analysis to determine which markets they wish to underweight or avoid. These managers likely use some form of country ranking evaluating market security, transparency and government stability, in their due diligence process. This is particularly true of emerging market debt portfolios.

For corporate debt, organizations are beginning to employ third party data providers to screen investment universes for issuers in order to identify corporations that violate the exclusionary policy. This becomes more difficult for private issuers. A more common approach to date is to perform regular reviews of fixed income, using either an internal team or an external service provider, to determine whether the holdings are in compliance with the exclusionary standards. In several cases, these reviews occur on an annual basis. After receiving the results of the annual review, pension organizations use the results of these reviews to identify issuers in question and initiate dialogues and, in extreme instances, initiate exclusion from the portfolio.

Targeted investments

In the fixed income space, ESG-targeted investments are not as common as in other asset classes. However, we have seen recent progress from investment managers in offering "green bond funds" or fixed income solutions for institutional investors looking for targeted ESG investments in this asset class. Opportunities to fund these types of projects through debt are often localized, sponsored by governments or regional development banks. Given the involvement of regional development banks, opportunities are available in emerging markets.

The World Bank has issued "green bonds" that support a variety of clean technology projects around the world. Since 2008, the World Bank has issued over USD $1.5 billion in AAA rated green bonds. To date, most of the investors have been large public or multilateral pension funds and larger investment managers.[54] The World Bank and other organizations continue the push to expand the market for these instruments as expenditures for these projects around the world increase.

Another form of targeted investment in this asset class is a social bond fund, which invests with community investment banks or development institutions with the aim of assisting communities in a particular region develop social services and infrastructure for an improved quality of life. A small number of investment managers offer bond funds with this type of mandate, largely comprised of affordable housing bonds and mortgage

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[54] The World Bank Green Bond, http://treasury.worldbank.org/web/WorldBankGreenBondFactSheet.pdf

securities. In the US, the largest investors in these funds are often banks who invest as part of their requirements under the Community Reinvestment Act.

A limited amount of public information is available as to which pension organizations have invested in fixed income targeted ESG vehicles. Data regarding the performance of these investments is also limited, given their recent development.

Fixed income: Summary of activities in ESG integration

As described above, the common RI activity in this asset class is the implementation of exclusionary criteria. A very small number of organizations utilize members of an internal RI team to gather country-level ESG data and prepare it for integration into the fixed income team's investment decision- making process. A summary of common approaches is provided here:

Activity	Frequency (Red: Low; Yellow: Medium; Green: High)
Fixed income	
RI policy that applies to fixed income	High
Inclusion of RI specialists or RI specialist research in the issuer due diligence process	Medium
Annual review of the fixed income portfolio for compliance with particular ESG standards	Medium
Use of the annual review results to identify issuers in question and initiate dialogues, requests for information, or exclusion from the portfolio	Medium
Use of RI specialist research to execute the annual review	Medium
Allocation to targeted fixed income investments	Low

Fixed income: Leading practices

Among the publicly available information reviewed for this report, several organizations stand out in terms of their activities in this asset class, particularly in their efforts to integrate RI specialists or RI specialist research in their investment due diligence process. A summary of these leading activities are described below:

Organization	Activity
Environment Agency Pension Fund (United Kingdom)	In its 2009 Responsible Investment Review, the Environment Agency explains that its fixed income investment managers employ specialist ESG research in order to use "best-in-class principles" in investment decision-making (100% of the fixed income portfolio is externally managed). Royal London Asset Management, which manages the global bond portfolio, uses EIRIS to assess the "extent to which a company mitigates its environmental impact." On a quarterly basis, the manager reports to the Environment Agency on the number of companies in the portfolio that EIRIS covers and the various scores of the portfolio holdings. European Credit Management uses environmental footprints from Trucost to identify risks associated with poor environmental management. [55]
Fonds de réserve pour les retraites (FRR) (France)	On an annual basis, the Responsible Investment Committee of the Supervisory Board uses information from EIRIS to review all companies whose securities (equities and bonds) are included in the FRR's portfolio in terms of their compliance with the principles of the Global Compact and conventions on banned weapons. The Committee then produces a list of companies that may generate reputational risk for the Fund, which is then used to recommend specific actions ranging from requests for information to initiation of dialogues with the companies in question. Occasionally, as a last resort, the Committee will recommend that a company be excluded from the portfolio.[56]
Universities Superannuation Scheme (USS) (United Kingdom)	On its website, USS explains that its RI team produces an annual ranking of countries in terms of key ESG risks for use in the sovereign debt selection process for emerging markets. USS uses this data for comparing countries when the fixed income team determines that financial returns and other factors are equal. The rankings are based on four base indices: ▪ Corruption Perceptions Index, Transparency International ▪ Human Development Index, UN Development Programme ▪ Environmental Performance Index, Yale & Columbia Universities ▪ Index of Economic Freedom, Wall Street Journal and Heritage Foundation[57]

Fixed income: Looking ahead

Looking to the future, as organizations evaluate how they can apply RI and ESG-related policies across asset classes, they may discover opportunities to leverage RI/ESG resources from other asset classes for ESG integration in fixed income. To further the discussion, Mercer highlights the following topics/proposals for consideration among RI industry leaders:

[55] Environment Agency Responsible Investment Review: Active Pension Fund, http://www.environment-agency.gov.uk/static/documents/Utility/Responsible_Investment_Review.pdf. June, 2009.

[56] The FRR and Responsible Investing 2009, http://www.fondsdereserve.fr/IMG/pdf/FRR_GB_IR09_WEB.pdf

[57] USS: Integration, http://www.uss.co.uk/UssInvestments/Responsibleinvestment/Integration/Pages/default.aspx

3.18 Identification of opportunities for engagement in fixed income, particularly during the development of an issue

3.19 Collaboration with issuers and or with investment banks who underwrite issuers (resources and experience from engagement within other asset classes can inform these activities, and investors can consolidate their resources in cases where exposure to a company or ESG issue spans asset classes)

3.20 Identification of ESG-targeted fixed income opportunities spilling over from other asset classes' investments in microfinance, infrastructure, and carbon finance (the RI community and the institutional investment community more broadly are well poised to consider these investments as conversations around new risk management tools and asset allocation models continue)

3.21 Identification of opportunities in fixed income involving third party sponsors of infrastructure projects (such as the World Bank)

Public equity

Highlights of ESG integration practices

Overview

Investors collectively have the most experience integrating ESG factors into public equity investing. Negative and positive screening, as well as voting and shareholder engagement, have a long history in this asset class. Even so, data sources, tools, and integration are continuing to develop. Engagement activities are also continuing to progress, with forums such as the PRI Engagement Clearinghouse facilitating collaboration and the sharing of experiences.

A variety of approaches and tools exist within the public equity asset class for incorporating RI, and will be explored further in the sections below:

- ESG integration – A consideration of ESG issues across public equity portfolios, beyond RI-branded investments
- RI-branded or ESG-targeted investments – Specific allocation to themed products, in addition to, or in place of, ESG integration
- Portfolio screening – An issues-based approach, which can be applied to the entire portfolio or specific screened products, and used in addition to or, or in place of, ESG integration
- Governance, voting and engagement – Portfolio management tools, to be applied, regardless of the investing strategy used above

Despite the long history and the wide uptake of ESG integration activities in public equity investments, challenges for responsible investors still remain. In terms of shareholder engagement, a successful engagement campaign can be very resource intensive and larger market capitalization means more diluted ownership for investors. The very large universe of global public equity investments also makes coverage of all companies difficult for the existing ESG research providers. For the largest global investors and for quantitative or emerging market investment managers, ESG research coverage of companies is a particular challenge.

Corporate disclosure is slowly improving and technologies for collecting and delivering the data are evolving as well.[58] ESG research providers are seeing more interest from their clients in engagement and are gearing their products towards that use. In addition, particularly in the asset management community, the line between screening and ESG integration can sometimes be difficult to distinguish. ESG issues are increasing taken into account to avoid potential risks and screening is used to avoid the most egregious offenders in areas of concern.

Academic and practitioner research demonstrating the relationship between ESG factors and corporate financial performance is widely available at the company or stock level. Generally, there is consensus that ESG factors are, in some sectors and situations, material to financial performance. However, within this asset class, asset owners have had difficulties documenting how ESG integration has impacted performance or generated social and/or environmental impact, outside of ESG-targeted investments. As discussed in the introductory section of this chapter, the concept of ESG integration is not simple. For one organization, ESG integration can mean proxy voting and active engagement, while for another organization it may mean a portfolio with minimum criteria for ESG performance. Therefore, it is best to address the performance evidence for individual approaches, realizing that it is available for some approaches more than others.

ESG integration

Many pension organizations indicate in their public reports that they attempt to integrate ESG factors into the internal and external decision-making processes across all assets in public equity. Different organizations accomplish this in different ways, although among them, voting and engagement activities are common.

Regardless of whether organizations use internal or external managers, a larger number of organizations allocate a portion of their funds to ESG-themed or RI-branded external managers or apply ESG exclusionary criteria across their equity portfolio than require ESG integration throughout the portfolio.

As described above, performance for ESG integrated strategies can be varied. Below is a table that displays the performance of 5 strategies branded as “sustainable” equity strategies. In Mercer’s experience, these strategies focus on ESG themes and employ a mixture of positive screening and minimal negative screening. Performance of these strategies does not necessarily represent the best or worst strategies in terms of investment performance or in terms of level of ESG integration. [59]

[58] See, for example, Bloomberg Launches ESG Data Service, http://www.moneymanagementletter.com/SubContent.aspx?ArticleID=2278589. August ,2009.

[59] Mercer Investment Consulting: Manager Performance Analytics. August, 2010.

Performance analytics: Global sustainably equity strategies Quarterly returns before fees from June 2005 to December 2009					
Global sustainable equity strategies	Returns			Standard	Tracking
	Total	Annual	Excess	Deviation	Error
	(%)	(%pa)	(%pa)	(%pa)	(%pa)
Fund 1	9.2	1.9	-1.0	21.9	2.5
Fund 2	20.2	3.9	1.0	21.0	3.3
Fund 3	13.1	2.6	-0.3	21.5	3.1
Fund 4	23.9	4.6	1.7	21.8	4.4
Fund 5	N/A	11.7	N/A	16.5	5.3
MSCI World	14.7	2.9	0.0	20.7	0.0

The above table demonstrates how a sample of global sustainable equity strategies performed against a mainstream benchmark from 2005-2009. This table shows that like any other equity investment, there is wide variation in strategies' performance depending on manager skill and specific investment criteria. In this case, these strategies are branded as sustainability or similar-type strategies, but they may employ different positive and negative screens or use different sustainability themes. There are other investment options available to investors where investment managers display a deep knowledge of ESG issues, but have not branded themselves as ESG or sustainability managers.

Externally managed assets

Some organizations integrate ESG factors into the external manager due diligence, selection and monitoring process. Several pension organizations are now incorporating ESG factors into their RFPs for new investment managers, regardless of whether or not they are looking for ESG-targeted or RI-branded strategies. These questions can focus on the manager's ability to adhere to the organization's existing RI policy, as well as more general questions on the managers' views on the materiality of ESG issues and their particular approach to integrating them in the investment process. In the US and Europe, sample questionnaires for investment managers have been published that are focused on climate change or RI more broadly. However, the "weight" that investors place on responses may vary widely depending on the particular mandate and the investors' existing RI policies.

Other organizations are questioning *existing* managers about their approach to ESG integration or specific ESG factors such as climate change. Railway Pension Investments (Railpen), HSBC and Linklaters recently published their Climate Change Investment Risk Audit: An Asset Owner's Toolkit, which contains a section including questions for investment consultants, asset managers and other advisors relating to the management of climate change risk.[60]

Other organizations engage a third party, such as a consultant, to conduct ESG-related due diligence on existing managers. The review can be qualitative or can be a review of the potential manager's current portfolio as compared to an ESG benchmark. Again, how the results are factored into decision making will vary based on the organization, its RI goals and objectives, and the scope of the investment mandate. The results of this review may also be used for engagement with portfolio companies or the investment managers.

Some pension organizations require that once hired, their external investment managers report on ESG integration activities on a quarterly or annual basis, regardless of whether or not they are managing an RI-branded or ESG-targeted fund. In select cases, pension organizations measure the carbon footprints or carbon efficiency of all their external investment managers, including those that are not RI-branded or ESG-targeted, on a regular basis.

These activities are relatively new processes and the degree of formality appears to vary significantly among investors. For most investors, these activities are useful data collection and benchmarking exercises, and provide year-over-year comparisons of how external managers are implementing RI policies. Pension organizations may benefit from discussing how they use this data and the lessons learned from collecting it to improve both internal and external application of RI policies.

Internally managed assets

Several organizations use an in-house RI specialist team to develop research or purchase ESG research from external providers for internal portfolios managers to apply to their stock selection processes. These organizations usually promote a collaborative relationship between the specialist team and other staff members, or encourage portfolio managers to use the available ESG-related information if no specialist team exists or is utilized in portfolio management.

As with externally managed assets, these are relatively new processes and the degree of formality appears to vary significantly among investors. Pension organizations may benefit from discussing methods of ensuring that the specialists or research sources are being used throughout the organization or methods of rewarding successful integration. In addition, there is more work to do concerning using ESG research and expertise, not just for stock selection, but for weightings and portfolio construction as well.

[60] Climate Change Investment Risk Audit: An Asset Owner's Toolkit, http://ec.europa.eu/enterprise/policies/sustainable-business/corporate-social-responsibility/reporting-disclosure/swedish-presidency/files/background_documents/climate_change_investment_risk_audit_en.pdf. Railpen Investments, HSBC, Linklaters. November, 2009.

RI-branded or ESG-targeted investments

Allocations to RI-branded or ESG-targeted investments are a fairly common approach to implementing an RI policy in this asset class. ESG-targeted allocations can include environmentally or sustainability-themed funds and/or governance/activist funds. RI-branded allocations can include "best-in-class" funds or funds that utilize negative screening criteria and often positive screening as well. These allocations are usually relatively small parts of the total public markets portfolio. They may also be "carved out" as a separate investment program. Primarily, the uptake of these funds has been for long-only vehicles, but Mercer has witnessed a growing universe of long-short funds focusing on ESG sectors or sustainability criteria. SRI funds, often using a combination of positive and negative screens are not often utilized by large pension organizations but are often offered by large investment managers involved in RI.

Although RI-branded or ESG-targeted investments in the public equity space can include emerging market companies, most funds available in the marketplace do not specifically focus on investing in sustainable emerging market companies. The universe of publically traded companies for which sustainability data is available, and the universe of emerging market companies that produce sustainability-themed products or services (including renewable energy) are not very large. Currently, there are efforts to improve ESG data coverage of emerging markets companies through new mandates such as the Emerging Markets Disclosure Project, the IFC's Sustainable Investing Project, and the development of RI products and indices in several emerging markets.[61]

The last decade, and particularly the last few years, has seen a great increase in the number of ESG-targeted public equity products that are drawing assets from institutional investors. Most prominent among them, and those that tend to have the longest track record, are environmentally themed products. These may be labeled as climate change, clean technology, renewable energy, water, sustainability or green-themed products and vary in terms of geography, diversification, market cap and other characteristics that impact risk and return. In some cases, these products are constructed in part based on benchmarks that use the carbon footprint, climate change-related risk or environmental performance of prospective companies as inclusion criteria. For example, several index providers have established carbon-risk-tilted versions of their established benchmark indices. These are sector-adjusted, so that the weighting of each sector remains the same as in the underlying mainstream index; however, individual companies are weighted according to their exposure to carbon risk relative to their sector peers. Information that companies submit to the Carbon Disclosure Project (CDP) is critical in determining the weighting for these indices.

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[61] Emerging Markets Disclosure Project, http://www.socialinvest.org/projects/iwg/emdp.cfm.

IFC's Sustainable Investing Project, http://www.ifc.org/ifcext/sustainability.nsf/Content/SustainableInvesting.

See, for example, Mexican Stock Exchange Hires EIRIS to Develop New Sustainability Index, http://www.eiris.org/files/press%20releases/Mexicanstockexchange2010.pdf. October, 2010.

Also see BM&F BOVESPA, Corporate Sustainability Index – ISE, http://www.bmfbovespa.com.br/indices/ResumoIndice.aspx?Indice=ISE&Idioma=en-US.

Asset managers have also created climate change benchmark indices, which track companies the manager feels are best placed to profit from challenges and opportunities relating to climate change. The indices that asset managers offer range from broad climate change-themed indices to more specific indices focused on specific challenges and opportunities in energy efficiency and energy management or water, waste and pollution control. Pension organizations such as New York State Common Retirement System and CalPERS have invested in these kinds of indices.[62]

Environmentally themed products vary in terms of potential RI "impact" or "effect", which may be dependent on whether the constituents of the portfolio are pure-play environmental companies or not. Other vehicles available to institutional investors that provide potential RI "impact" include some focused on companies with favorable community or stakeholder policies and performance, as well as those that target a concentrated group of companies on governance issues (activist funds).

Parallel to the development in the "green" public equity space, the market has experienced an increasing number of investment managers launching "best-in-class" or sustainability "tilted" portfolios, where the portfolio is biased towards a diversified group of companies with the highest ESG performance in each industry. As previously discussed, there are a variety of approaches to building portfolios integrating ESG factors and this makes it difficult to discuss the performance of strategies in a general manner. However, as presented in the introduction of this chapter, there is some evidence that an ESG-tilted strategy can perform well. In addition, ESG research providers have conducted additional research.

The graphic below is based on data from Sustainable Asset Management (SAM), an ESG research and investment management firm. Their research supports the Dow Jones Sustainability Indices as well as their internally managed investment products. SAM's sustainability assessments show that from 2000-2009, sustainability leaders outperformed sustainability laggards by a large margin, even throughout the down markets during that period. [63]

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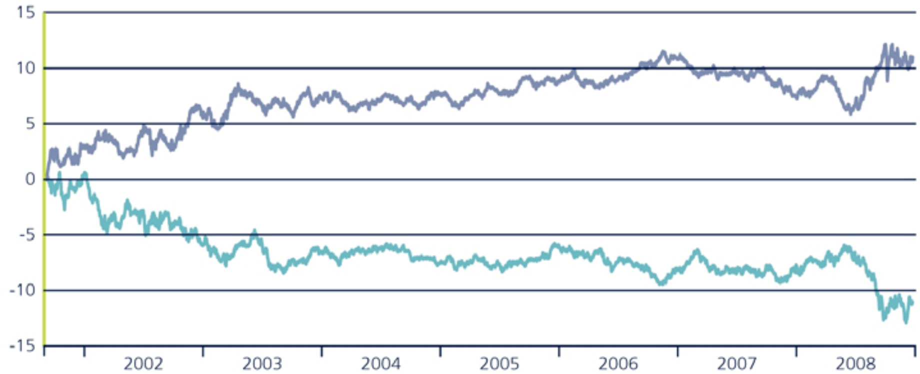
[62] New York State Retirement Fund Invests $200 Million in Green Indexes, http://www.wbcsd.org/plugins/DocSearch/details.asp?type=DocDet&ObjectId=MzUzNzg. August, 2009.

CalPERS Statement of Investment Policy for Internally Managed Global Enhanced Equity Strategies, http://www.calpers.ca.gov/eip-docs/investments/policies/inv-asset-classes/equity/int-equity/global-enh-strgy-int-man.pdf. May, 2010.

[63] Sustainable Asset Management
* Sustainability leaders (Top 20%), laggards (Bottom 20%); Benchmark: Companies rated on the basis of the SAM Sustainability Assessments, total sustainability score (economic, environmental, and social criteria)

Percentage outperformance of ESG leaders vs. laggards*



Portfolio screening

As discussed in the fixed income section, some investors identify exclusionary criteria based on international conventions and work to ensure that all holdings in the public equity portfolio are in compliance with these exclusionary screens. In some countries, screening investments based on particular criteria is mandated by law, so pension organizations must abide by those requirements. These criteria may be based on company's operations in a specific county or to avoid specific reputational or business risks. Exclusionary screening is most often applied in the fixed income and public equity asset classes.

Exclusionary screens are most often focused on the companies or particular business activities seen to be most egregiously negative or potentially harmful to society. Some of the most common screens include the tobacco industry and the weapons industry (cluster bombs, mines or weapons of mass destruction). As the industry has developed, screening research and processes have become more sophisticated allowing investors to implement screens across more qualitative issues such as human rights, environmental issues, governance, and more holistically on a minimum standard of ESG criteria. This latter approach often involves decisions being made by an internal or external committee with expertise across ESG issues.

Responsible investors acknowledge that investment risk and violations of various ethical norms often go hand-in-hand. Discussions around negative screening among pension organizations and the asset managers often focus on investment risk, and acknowledge ethics as one cause of this risk.

Among the peers reviewed for this report, positive screening is not usually applied across the total public equity portfolio as negative screening is, but rather is applied within particular RI-branded or ESG-targeted mandates. As such, performance again can vary substantially with approach and manager skill. The following table is a sample of global equity screened funds, most with a combination of positive and negative screens.

Performance is mixed but there are some indicators of outperformance compared to the benchmark.[64]

Performance analytics: Global ESG-screened equity strategies Quarterly returns before fees from March 2005 to December 2009					
Global ESG-screened equity strategies	Returns			Standard	Tracking
	Total	Annual	Excess	Deviation	Error
	(%)	(%pa)	(%pa)	(%pa)	(%pa)
Fund 1	13.5	2.7	0.2	19.1	6.1
Fund 2	13.7	2.7	.02	18.6	5.4
Fund 3	24.1	4.6	2.1	18.5	5.8
Fund 4	11.1	2.2	-0.3	18.8	3.6
Fund 5	15.2	3.0	0.5	18.6	3.7
MSCI World	12.5	2.5	0.0	17.8	0.0

Governance, voting and engagement

One approach to implementing RI policies that is nearly universal in its application is an active corporate governance program that includes voting and often some level of collaborative or individual engagement with portfolio companies. Several responsible investors make a point of making corporate governance the centerpiece of their RI activities, deemphasizing (or ruling out) other approaches such as exclusionary screening.

As discussed in the introductory section of this chapter, there is evidence that the market can reward those companies believed to be improving corporate governance practices over time. However, governance or activist investment strategies that select a few companies to target for governance or business management improvements tend to be very concentrated and therefore have volatile performance.

Some organizations have chosen to develop a “Focus List” or similar approach to voting and engagement. This entails the development of a set of criteria that will identify certain companies that require additional, focused dialogue. The criteria may be a combination of ESG indicators and investment performance indicators. The criteria vary by organization, but tend to cover their home markets and ESG criteria that are stated priorities (for example: corporate governance, human rights, or diversity). Some investors identify a number of focus areas (such as executive compensation or human rights) and identify targets for engagement from within their holdings based on these factors, as well as a consideration of other factors (such as size of holding and the likelihood of engagement success).

[64] Mercer Investment Consulting: Manager Performance Analytics. August, 2010.

Once a holding is part of the focus list, the asset owners may initiate dialogue or commit to in-person attendance at annual meetings or pay special attention to voting issues. If engagement is not successful, the owner may name the company publicly and use divestment as a last resort.

Engagement overlay providers take a similar approach, where clients' priority issues and portfolio holdings are used to find common and logical targets for engagement. In this regard, the emergence of engagement overlay services has facilitated the active owners' ability to consolidate assets and interests. Depending on the company's response to the engagement, the provider may progress from "soft" tactics, such as letter writing, to the filing of shareholder resolutions, or to the release of public statements. Though the organizations offering these services are quite experienced, the service models themselves are quite new and may merit further discussion among investors.

As recent corporate engagement campaigns show, the RI industry is quite sophisticated with regards to these active ownership practices. A large number of pension organizations and asset management firms have in recent years, honed their ability to organize and collaborate, present investment-based arguments, and get companies to respond. The number of shareholder resolutions that are withdrawn each year has been rising sharply and public and corporate advocacy campaigns have benefited from growing visibility worldwide.

Common topics for corporate engagement campaigns vary across sectors and regions, but there are several ESG factors that cut across these differences. Diversity as it relates to the Board of Directors or company workforce, for example, is a broadly applicable factor for publically traded companies. Pension organizations and asset managers have launched corporate engagement campaigns around diversity. In addition to initiating engagement campaigns relating to Board of Directors' diversity, investors can also promote diversity on corporate boards through voting in regularly occurring Board Elections.

Beyond focusing on particular ESG issues, pension organizations and asset management firms have continued to extend the scope of corporate engagement campaigns to companies' supply chains, either initiating campaigns with public companies based on events at suppliers' factories or initiating top-down campaigns that question companies about their suppliers' practices. For example, a recent bottom-up campaign revolved around a series of worker suicides at a manufacturing facility in China that supplies electronics to Apple, Dell, Hewlett-Packard and other companies.[65] A top-down campaign recently originated with investors sending letters to companies in the Bovespa Brazilian Stock Exchange asking for information regarding their policies and practices in monitoring slave labor in their supply chains.[66] In either case, investor

[65] Update: Suicides at Electronics Manufacturing Facilities. UN PRI Engagement Clearinghouse. October, 2010.

[66] Update: Final Report on Slave Labor in Brazil. UN PRI Engagement Clearinghouse. November, 2010.

campaigns of this nature can effectively leverage active ownership practices to further extend the impacts of engagement. While these campaigns do not apply to all sectors of the market, they are common in retailing and durables manufacturing.

Large asset owners have also recently increased their presence in public policy debates. Leading up to the Copenhagen Climate Summit and then around financial market reform, pension funds voiced their interests and perspectives in a number of different public forums. The RI industry more broadly has followed suit as the following examples demonstrate:

- The PRI has launched a public policy work steam, entitled the PRI Public Policy Network, which aims to bring together public policy representatives to discuss and share best practices related to RI. PRI explains that “the network will also engage responsible investors to share their views on how regulation and public resources can be leveraged to encourage more sustainable capital markets.” [67]
- The US Social Investment Forum has disbanded its semi-independent Advocacy and Public Policy Working Group in order to make public policy a full-fledged program within the forum. [68]
- The global Network for Sustainable Financial Markets (NSFM), which is a non-partisan network of individuals that work in the financial sector, perform academic research relating to financial markets, or have a particular interest in long-term investing. The Network seeks governance reforms across global markets and includes, among others, consultants, asset managers, asset owners, and index providers.[69]

Voting and engagement (corporate and public policy) will continue to be a leading approach to ESG integration within the public equities asset class. More and more examples of engagement successes and collaborative initiatives are making their way into news cycles and RI reports. At the same time, new ESG issues and rationales for engagement continue to emerge as ESG investment risks and opportunities become more visible and quantifiable. Collaborative forums and initiatives, as well as new research and services from providers further equip investors to enhance their voting and engagement activities.

Public equity: Summary of activities in ESG integration

Responsible investors have developed a number of mechanisms for incorporating ESG and sustainability into their overall public equity portfolio. Some investors are specifically focused on environmental investing, while others are continuing to develop their approach internally by having RI or ESG specialist staff work with internal portfolio managers to help analyze companies and form views about ESG-related risks and

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[67] Principles for Responsible Investment Work Streams, http://www.unpri.org/workstreams/#8

[68] Social Investment Forum: Advocacy & Public Policy, http://www.socialinvest.org/projects/advocacy/

[69] Network for Sustainable Financial Markets, http://www.sustainablefinancialmarkets.net/

opportunities within the public equity market. Increasingly, investors are reporting a formal process for evaluating or monitoring investment managers in terms of ESG integration. A summary of common practices is provided below:

Activity	Frequency (Red: Low; Yellow: Medium; Green: High)
Public equity	
Voting and engagement	
Requirement of internal and/or external managers to publicly disclose voting records on a quarterly or annual basis	High
Initiation of one-on-one or collaborative engagement campaigns with portfolio companies	High
Participation in collaborative networks that engage on public policy issues	High
Other implementation	
Initiation of targeted mandates, including “best-in-class” portfolios or environmentally themed investments	High
Requirement of external managers to report on ESG integration activities on a quarterly or annual basis	High
Annual review of the equity portfolio for compliance with particular ESG standards (the standards vary depending on the organization)	High
Incorporation of ESG-related questions into RFPs for new external managers, regardless of the mandate	Medium
RI specialist team included in the investment decision making process	Medium
Assessment of equity portfolio carbon footprint or carbon efficiency	Low
Assessment of the suitability of particular indices to act as benchmarks for the passive or active portfolios, given the organizations’ RI policy	Low

Public equity: Leading practices

Within this asset class, leading practices are varied, based on the number of different approaches organizations use to incorporating RI into the investment process. Some examples across approaches are provided below:

Organization	Activity
ESG integration	
Republic of South Africa Government Employees Pension Fund (GEPF) (South Africa)	In a public "implementation statement," the GEPF's passive equity portfolio is entirely invested in companies listed on the Johannesburg Securities Exchange according to the benchmark's weightings. The Fund plans to use external (EIRIS) and in-house research to determine how companies in the index are managing ESG issues. Subject to Board approval, the Fund will then re-weight the current weightings used to benchmark the passive equity investments. This will be undertaken in best-in-class, sector-neutral basis. This will be a gradual process. The GEPF will ensure any reweighting has an associated engagement strategy, so that the reweighting is undertaken on the basis of how responsive companies are to engagement and how likely they are to manage ESG issues in the future. Details of the reweighting will not be publically disclosed, but the Fund will publically report on ESG integration in its passive equity portfolio. It will review the reweighting on an annual basis. Subject to Board approval, the GEPF may require its active investment managers to track active equity investments to the internally re-weighted benchmark or other benchmark variations derived from it.[70]
Governance, voting and engagement	
CalPERS (United States)	Since 1988, CalPERS has published an annual Focus List, which identifies US companies that exhibit poor economic performance and corporate governance. After adding a company to the List, CalPERS engages with the company to reform its governance practices. The names of the companies on the List and CalPERS' concerns regarding the company are available on the fund's corporate governance website.[71] In 2010, CalPERS did not issue a Focus List, since all the companies that CalPERS was considering for inclusion improved their governance practices after being approached by CalPERS' corporate governance staff.[72]

[70] Government Employees Pension Fund Responsible Investment Implementation: Integrating ESG Issues in Investments, http://www.gepf.gov.za/Investments/Documents/ESG%20Issues%20in%20Investment.pdf. June, 2009.

[71] CalPERS Corporate Governance: Reform Focus List Companies, http://www.calpers-governance.org/focuslist/reform-companies

[72] Success Spurs CalPERS to Nix Focus List for 2010, http://www.calpers-governance.org/utilities/redirect-page?url=http://www.pionline.com/article/20100517/PRINTSUB/305179981&name=Pensions+and+Investments. Pensions and Investments. May, 2010.

Organization	Activity
Norwegian Government Pension Fund Global (GPFG) (Norway)	In order to enhance opportunities for impacting companies with engagement activities, the GPFG identifies focus areas that are particularly relevant for its portfolio. These focus areas are as follows: ▪ Equal treatment of shareholders ▪ Shareholder influence and board accountability ▪ Well-functioning, legitimate and efficient markets ▪ Children's rights ▪ Climate change ▪ Water management For the last three focus areas, Norges Bank has published "expectation documents" that review problems and risk factors associated with the issues. The documents serve as a point of departure for engagement, and set expectations for global companies. For climate change and children's rights, Norges Bank annually assesses how companies in the portfolio meet these expectations and publishes a compliance report. [73]

Public equity: Looking ahead

Some emerging practices that responsible investors may consider to set the stage for discussion and continuing evolution within this asset class include the following:

3.22 Investor involvement in creating/seeding new products (investors may see a benefit to seeking ESG sector specific expertise outside their in-house RI teams and, in response, seed or collaborate in the development of new products/approaches)

3.23 Continued development of specific expectations for external managers as pension organizations develop their RI implementation strategies

3.24 Further discussion on how to measure and monitor ESG integration progress and use the data to improve both internal and external application of RI policies

3.25 Further discussion of methods for ensuring that RI specialists or research sources are being used throughout the organization

3.26 Discussion of how ESG integration practices apply to passively-managed equity mandates

3.27 Continued research into how ESG integration impacts risk management and equity portfolio performance attribution

3.28 Continued assessment of the role of ESG in overall public equity portfolios

[73] Government Pension Fund Global Responsible Investment, http://www.regjeringen.no/upload/FIN/brosjyre/2010/spu/english_2010/index.htm

Other investments

Highlights of ESG integration practices

Three types of investments that are gaining increasing attention in the RI community are derivatives, commodities, and hedge funds. ESG integration is a relatively new activity within this space and is still in the early stages of expansion. Indeed, only a select few pension organizations discuss these types of investments in their public RI reports.

Derivatives

Very few pension organizations or asset managers publically discuss the role that derivatives play in their RI strategies. Derivatives are not simply instruments of speculation, but rather are integrated into a variety of asset class portfolios including public equity and fixed income in order to manage portfolio risk. However, the varierty of roles derivatives play within many portfolios means that transparency around the use of derivatives is often limited.

The International Swaps and Derivatives Association (ISDA) publically advocates for improved transparency standards around the use of derivatives.[74] Although activities by responsible investors around these standards appear to be limited based on the publically available information reviewed for this report, it is possible that organizations will increase public discussion around these issues in the future.

While responsible investors may be interested in improving transparency and overall responsibility of the use of derivatives, there are additional applications of derivatives to which ESG considerations can be applied. Investors may be interested, for example, in examining how commodities impact food prices, and determining the potential for sustainable or ESG-themed derivatives related to commodities.

Commodities

Timber and agricultural land are particular types of commodity investments that can have RI applications. A select number of pension organizations, including ABP and APG, require all forestry investments to be certified by the Forest Stewardship Council (FSC) or the Sustainable Forestry Initiative. Targeted investments in forestry are becoming more common among responsible investors. PGGM, for example, has made a targeted investment in fund focused on forestry conservation and the management of ecosystem rights, such as carbon dioxide allowances.[75] Asset managers increasingly offer funds

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[74] See, for example, the Big Bang and the Small Bang Protocol (2009), both available at www.isda.org

[75] APG Responsible Investment Report 2009, http://www.apg.nl/apgsite/pages/images/40.0802.10%20APG%20Responsible%20Investment%20Report%202009_tcm124-109870.pdf

that invest in forest management companies, as well as forest projects that meet sustainability criteria or qualify for FSC certification.[76]

In recent years, carbon has emerged as a new type of liquid commodity and is attracting the attention of pension organizations looking to make targeted investments. As carbon markets are in their infancy, this type of security is relatively new and data regarding historical performance is limited. Carbon markets are, however, rapidly growing. Asset managers have launched carbon funds ranging from passive funds tracking the performance of credit issues of major carbon credit trading schemes, to active funds financing pollution-reduction projects and providing liquidity to carbon markets.[77]

In some cases, responsible investors are concerned that some commodities or related securities are too short-term in nature to align with their RI policy, or too speculative to contribute to a sustainable investment strategy. The Fonds de réserve pour les retraites' (FRR's) Responsible Investment Committee, for example, issued a statement against investments in derivatives related to food and agricultural commodities, as such investments "could tend to encourage purely speculative movements in basic foodstuffs," and thereafter altered its investment strategy to reflect this view.[78]

Hedge funds

Similar to investments in commodities, responsible investors may be worried that hedge funds are too short-term or speculative in nature to align with their RI policy. A select number of pension organizations, however, have taken steps to ensure that their allocations to hedge funds do in fact align with their policies. These steps range from improving the transparency of hedge fund investments to including RI considerations in the due diligence process for new placements.

Several pension funds, including CalPERS, USS and PGGM, have begun to employ segregated, managed accounts for hedge fund investments in order to improve transparency and control over holdings. In a public statement, PGGM noted that the increasing control over holdings in this type of investment will allow it to better apply the RI policy.[79]

In terms of targeted investments, allocations to hedge funds investing in ESG-related securities are less commonly discussed in the public domain. Asset managers have,

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[76] Sustainable Alternatives: Sustainable Investment Opportunities for Pension Funds in Alternative Asset Classes. UK Social Investment Forum. November, 2008.

[77] Sustainable Alternatives: Sustainable Investment Opportunities for Pension Funds in Alternative Asset Classes. UK Social Investment Forum. November, 2008.

[78] The FRR and Responsible Investing 2009, http://www.fondsdereserve.fr/IMG/pdf/FRR_GB_IR09_WEB.pdf

[79] PGGM Unveils Exclusive Hedge Fund Platform, http://www.ipe.com/news/pggm-unveils-exclusive-hedge-fund-platform_37636.php. October, 2010.

however, launched environmentally themed hedge funds or hedge funds that apply broader RI principles. In the US, hedge fund strategies that take an activist approach focus on corporate governance and take an active role in the governance of investee companies

As previously discussed, there is much debate amongst practitioners and academics of the relative merit of activist hedge funds. Hedge fund activism differs from traditional institutional activism in a number of ways. First, it tends to be directed at significant change in individual companies (rather than small, systemic changes), it is costlier and tends to be strategic and ex ante to anticipate and drive change (rather than react to ad hoc events).[80]

Another aspect to consider in the context of allocating to hedge funds is the governance standards of the vehicles themselves. Hedge funds are complex investment strategies that are not regulated to the same degree as other investment vehicles, raising potential risks for institutional investors in terms of low transparency and governance standards. Furthermore, the governing body of the hedge fund itself varies depending on a number of factors, including the type of business entity or the jurisdiction in which the fund is organized, and independent directors' ability to oversee a hedge fund can be constrained by the fund managers.[81]

For these reasons, academics argue that the agency problems with hedge funds are more like those found in a partnership structure than those found in institutional asset management firms. [82] As a result, academics hold that investors should evaluate hedge fund investment opportunities as stringently as they would when considering investment in other partnership structures (rather than apply the same process and criteria as for traditional fund structures).

Other investments: Summary of activities

ESG integration activities in this area are still in early stages, with very few pension organizations publically discussing their approach to applying the RI policy or implementation plan to commodities or hedge fund investments.

As organizations devote more resources to assessing which ESG factors are relevant to these types of investments, how to integrate them and which managers share these views and capabilities, we expect ESG integration in this area to become more widespread.

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[80] Kahan, M, and Rock, E.B. Hedge Funds in Corporate Governance and Corporate Control. Scholarship at Penn Law Working Paper. May, 2007.

[81] Principles and Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets. http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf. January, 2009.

[82] Lehmann, B.N. "Corporate Governance and Hedge Fund Management", Federal Reserve Bank of Atlanta, Economic Review, Q4. 2006.

Activity	Frequency (Red: Low; Yellow: Medium; Green: High)
Derivatives	
Policy statement or public disclosure specific to derivatives	Low
Commodities	
Identification of material ESG factors for various types of commodity investments	Medium
Allocation to targeted commodities investments such as carbon funds or sustainable forestry	Medium
Incorporation of ESG factors into standard due diligence	Low
Policy statement with criteria specific to commodities	Low
Hedge funds	
Identification of material ESG factors for hedge funds	Medium
Incorporation of ESG factors into standard due diligence	Medium
Allocation to targeted hedge fund investments	Low
Policy statement with criteria specific to hedge funds	Low

Other investments: Leading practices

Among the publically available information reviewed for this report, some organizations stand out in terms of their activities in this space relative to their peers. Two examples are provided below:

Organization	Activity
ABP (Netherlands)	Since January 2009, ABP has required that investment proposals for illiquid investments, including commodities and hedge funds, submitted to the committee of senior managers must include an analysis of relevant ESG issues. The in-house team of 8 ESG specialists is directly involved in the preparation of all relevant proposals and in the analysis of how the responsible investment policy can be applied. For externally managed illiquid assets, managers must demonstrate that they have an appropriate policy and are required to report regularly on their performance.[83]
APG (Netherlands)	In 2009, APG's Sustainability and Corporate Governance team analyzed social and environmental issues that can arise from new investments in commodities and hedge funds. In the case of a hedge fund investing in energy projects in developing countries, APG required the manager to adopt a policy complying with the International Finance Corporation's social and environmental performance standards and to report regularly on the implementation of that policy. [84]
Universities Superannuation Scheme (USS) (United Kingdom)	USS integrates RI considerations into the standard due diligence process for hedge fund investments, with the RI team conducting interviews with relevant staff at the hedge fund and forming an "RI opinion" that is shared with the alternatives team to inform their investment decision.[85]

Other investments: Looking ahead

Based on the information regarding commodities and hedge funds available in the public domain, particular topics and trends stand out as being especially relevant to the future development of ESG integration within this asset class. For this reason, Mercer highlights the following topics for consideration among RI industry leaders:

3.29 More research and case studies regarding ESG issues in commodity, derivative and hedge fund investing

3.30 Consideration of the governance structure of hedge funds themselves and how this relates to strategic asset allocation

3.31 Increased transparency around the use of derivatives across asset classes

3.32 Consideration of how derivative products can provide incentives for sustainability or promote good governance

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[83] 2009 ABP Responsible Investment Report, http://www.abp.nl/abp/abp/images/VVB_engels_web_tcm108-107977.pdf

[84] APG Responsible Investment Report 2009, http://www.apg.nl/apgsite/pages/images/40.0802.10%20APG%20Responsible%20Investment%20Report%202009_tcm124-109870.pdf

[85] USS: Integration, http://www.uss.co.uk/UssInvestments/Responsibleinvestment/Integration/Pages/default.aspx

3.33 Identification of innovative opportunities for hedge funds and commodity/derivative investors interested in making ESG-targeted investments

3.34 Increased industry collaboration regarding time horizons and speculation and impacts on financial markets

4

Reporting frameworks

Overview

Most organizations with RI or ESG-related policy statements issue periodic reports in order to demonstrate how they are implementing or plan to implement their policy. Depending on the content of the policy statement, the periodic report will focus on broad RI implementation, and/or on a specific ESG issue (or issues) of priority for the organization (such as corporate governance).

These reports are typically designed to represent the organization’s approach to addressing RI issues that are increasingly important, but may be relatively new to stakeholders. As a result, the reports often describe approaches and highlight examples of successes. In comparison to traditional financial reporting frameworks, RI or ESG-related reports more closely resemble an annual report than financial statements. The six principles of the UN PRI are sometimes referenced in the report to demonstrate how a signatory is implementing the Principles, or be used as a framework for the report.

Responsible investors also distribute information on their ESG integration activities through responses to the annual PRI assessment, which some signatories (less than half of all PRI signatories) make public. Among the peers reviewed for this report, most of the organizations that are PRI signatories make their responses public.

Investors may also use press releases and other media forums to announce new ESG mandates, goals or milestones, including companies to be excluded from portfolios. However, RI reports remain the most reliable and thorough method for reporting on ESG integration activities within asset classes.

Responsible Investment reports

Most of the peer organizations issue an annual responsible investment report in addition to an annual investment report. However, a recent report from the United Nations Conference on Trade and Development reviewed the world's largest pension organizations and determined that despite a large number of funds having commitments to RI, a small portion of them issue annual reports that describe their RI activities.[86]

Annual RI reports are relatively new (less than 5 years) activities for these organizations, but have developed along with commitments and approaches to integration. A small number of organizations issue responsible investment reports or updates on a quarterly basis, although these tend to be focused on disclosing the quarter's engagement and proxy voting activities.

While some organizations discuss quantitative targets or explicit goals for future implementation of the policy, this is not a common feature of RI or ESG-related reports at this stage. Figures relating to asset allocation (portions of total fund or asset class that has integrated ESG) are the most common form quantitative disclosure. As ESG integration is a process for many institutional investors, quantitative targets or actions tend to be disclosed periodically as they are approved or funded. As with policy statements, public reporting needs to balance transparency with the necessary measured approach that many investors are taking to ESG integration.

A select few organizations use an integrated reporting framework, in which RI objectives and outcomes are integrated into the annual investment report. In these cases, the organization has integrated its RI policy into its main Investment Policy Statement. When disclosing annual performance of the investment portfolio and implementation of the policy, these organizations work RI-related activities seamlessly into the discussion.

Mercer encountered a small number of reports that indexed their content to Global Reporting Initiative guidelines. Compliance is noted in two formats: an appendix table or separate document showing indicators and where in the report they are addressed, or noted throughout the report, at the beginning of each topic section.

Corporate governance reports

In cases where an organization has a stand-alone corporate governance policy in place of a broad RI policy, the organization usually issues an annual corporate governance report. This type of report focuses on proxy voting and corporate engagement activities, but may briefly describe how the investment team is incorporating governance or other ESG factors into investment decision-making processes. The approach to reporting is

[86] Investment and Enterprise Responsibility Review: Analysis of Investor and Enterprise Policies on Corporate Social Responsibility, http://www.unctad.org/en/docs/diaeed20101_en.pdf. United Nations Conference on Trade and Development. 2010.

similar to annual RI reports: key issues (in this case, executive compensation or board diversity) typically drive the content and structure of the report.

These reports also include metrics relating to votes cast and engagements initiated. This is an area where data is often readily available regarding how votes compare to management recommendations, how many engagements were initiated or completed and with what result, or collaborative engagement initiatives and their scope and success. Engagement likely represents the best opportunity to offer concrete examples of action that investors can demonstrate to stakeholders who may be unfamiliar with ESG integration.

Other reporting frameworks

A small number of peer organizations produce sustainability or corporate social responsibility (CSR) reports. These types of reports discuss operational aspects of the organization, including energy use and waste management. In some cases, these reports are provided on a stand-alone basis, as separate from the annual investment reports, the RI policy or the RI report. In other cases, the discussion of operational goals related to energy and resource efficiency and/or waste management is included in the annual investment report.

Organizations with RI or ESG-related policy statements usually make them available on their website, along with related materials. The structure of these websites varies: while some organizations provide the majority of information on their website, others list drivers of RI policies and provide links to their reports and policies. Websites also offer an opportunity to provide more frequent updates outside of the annual report schedule. Investors may dedicate sections of the website to activities in certain asset classes or the latest voting or engagement activities.

Specific aspects of reporting frameworks

Measurement and benchmarking of policy implementation

As previously mentioned, most RI reports discuss activities in qualitative terms, except in relation to proxy voting and engagement activities, for which organizations provide figures around votes executed, firm’s engaged, and resolutions filed. A small number of organizations, however, use measurements, metrics, or benchmarking within their RI reports to assess how other aspects of the RI policy are being implemented.

Within this small sample, organizations disclose the following metrics or measurements:

- Year-on-year comparisons of metrics that relate to specific asset classes (for example, changes in the carbon efficiency of listed equity funds)
- Key performance indicators for aspects of RI policy implementation

In order to convey how the total fund RI policy is being implemented, some organizations disclose how their asset allocation is related to ESG factors within their RI reports. These organizations provide the following:

- Percentage of assets in the total fund for which ESG factors are integrated into the investment decision-making process and, in some cases, a year-over-year comparison of this figure
- Percentage of assets in specific asset classes (public equity, property, fixed income, private equity) for which ESG factors are integrated into the investment decision-making process

The percentage of assets for which ESG factors are being integrated, and the extent to which it is occurring, is an item within the PRI annual assessment, so funds that make their responses public release this information.

In relation to total fund asset allocation, some organizations indicate that they have already or are currently assessing how various consequences of climate change might impact strategic asset allocation of the total fund.

Risk management frameworks and ESG factors

It is not common for organizations to disclose detailed information relating to risk management frameworks and ESG factors in their RI reports or other public forums. The few funds that do disclose this type of information, however, describe a common approach to managing the risks relating to ESG factors. This approach involves the annual (or more frequent) monitoring of portfolio holdings across ESG issues in order to determine the portfolio's related risk exposure. Following this review, the funds use the review to identify portfolio companies for engagement activities. They also use monitoring results and ongoing engagement activities to identify unresponsive companies or companies that violate specific organization policies, which will usually lead to exclusion from the portfolio.

Use of external service providers

A large number of organizations disclose publicly that they rely on external service providers to some degree. Most of the organizations use external service or research providers for engagement and proxy voting. Some funds use external service providers for monitoring compliance with various ESG standards or conventions such as the Global Compact. Other organizations use external research providers or advisors to monitor or evaluate potential managers or potential securities investments in the public equity and fixed income asset classes.

Roles and responsibilities

Within RI reports, it is common for organizations to identify a board committee or a department that is responsible for implementing the RI policy. Many organizations have a specific committee (board, or otherwise) or department that is responsible for overseeing general RI activities or a specific aspect of RI activities (for example, proxy voting, engagement or exclusionary policy implementation).Among the peers, almost all of the organizations explain that members of investment staff, in addition to the RI specialists or committee members, play a role in implementing the policy and work in a collaborative fashion.

Summary of reporting frameworks

Most organizations with RI or ESG-related policy statements issue periodic reports in order to demonstrate how they are implementing or plan to implement the policy. The majority of these reports take the form of an annual RI report, but some organizations issue stand-alone corporate governance reports or CSR reports. The level of detail within these reports varies. An overview of the reporting frameworks that organizations use is provided here:

Activity	Frequency (Red: Low; Yellow: Medium; Green: High)
Reporting	
Annual Responsible Investment reporting	High
Responsible Investment section of public website	High
Quarterly Responsible Investment updates/reports	Medium
Reporting in line with Global Reporting Initiative guidelines	Medium
Stand-alone corporate governance reports	Medium
Stand-alone sustainability or corporate social responsibility reports	Medium
Integrated reporting (substantial incorporation of RI activities into annual investment report)	Low

Reporting frameworks: Leading practices

RI reporting is in various stages of development among investors as their respective programs develop. Currently, there are some examples of organizations that have adopted innovative or comprehensive approaches. Three such reports are described below:

Organization	Activity
Fonds de réserve pour les retraites (FRR) (France)	In its 2009 RI report, the FRR provides a year-over-year comparison (dating back to 2004 or 2005) of the quantitative indicators it uses to monitor the implementation of 3 out of the 5 strategic pillars of the RI strategy. The pillars are as follows (the 3 associated with quantitative indicators are italicized): ▪ *ESG integration* ▪ *The prevention of reputation/image risks* ▪ Taking environmental issues into account ▪ *Exercising proxies* ▪ Support for research[87]
PGGM (Netherlands)	In its 2009 Responsible Investment Annual Report, PGGM provides a table entitled, "results and targets of key performance indicators," which uses various quantitative metrics to compare implementation of the RI policy between 2007 and 2009, along with targets for 2010. [88]
VicSuper (Australia)	VicSuper's 2009 Sustainability Report, which is assembled in accordance with the Global Reporting Initiative's G3 Guidelines, is a combination of an annual investment report, an annual responsible investment report, and an annual sustainability operating report. The comprehensive report is divided into sections based on the Fund's 7 key strategies for "building a sustainable superannuation fund," which fully integrate various ESG factors. The key strategies are as follows: ▪ Deliver value ▪ Invest for the long term ▪ Attract, develop and retain great people ▪ Maintain sound governance and accountability ▪ Continue financial stability and growth ▪ Minimize environmental impact ▪ Foster effective partnerships[89]

Looking ahead at reporting on ESG integration

Because RI reporting is a relatively new activity, there is room for RI reports to develop and become more comprehensive sources of information regarding policy, policy implementation, strategic planning and performance. Investors have recently made it clear that best practices for public companies in reporting sustainability performance encompass quantitative performance indicators, year-over-year comparisons of data, discussion of strategic approaches, and targets for future implementation. It is likely that the investment community and stakeholders will expect the same type of reporting from

[87] The FRR and Responsible Investing 2009, http://www.fondsdereserve.fr/IMG/pdf/FRR_GB_IR09_WEB.pdf

[88] PGGM Responsible Investment Annual Report 2009, http://www.pggm.nl//Images/10-3538%20PGGM%20VB%20Jaarverslag%20UK-02-LoRes_tcm21-165939.pdf

[89] VicSuper Sustainability Report 2009, http://www.vicsuper.com.au/resources/documents/Full_Sustainability_Report_1109.pdf

responsible investors over time. These types of practices are emerging among the organizations reviewed for this report.

Based on the information reviewed in this report, looking forward Mercer would identify the following reporting activities as emerging best practices and encourage consideration of the following topics:

4.1 Provision of information regarding RI or ESG-related policies and activities in a centralized location on the organization’s website – including links to applicable policy documents, guidelines and reports – for wide-spread internal use and external reference

4.2 Integration of information relating to RI and ESG factors into the public annual investment report

4.3 Provision of quantitative targets or goals for future implementation of the RI or ESG-related policies

4.4 Inclusion of measurements, metrics or benchmarking in public reporting to demonstrate the implementation and investment impact of the polices

As organizations gain experience in implementing ESG-integration policies and reporting on progress, gather resources and build internal capacity for RI programs, we expect that these practices will become more standardized and less challenging over time.

5

Summary and conclusion

Total fund ESG integration is an aspirational goal. There will always be new issues, new research and new ways to consider ESG factors alongside more traditional investment characteristics. Many asset managers and pension organizations admit to being in the early stages of implementing ESG-related policies (at least within specific asset classes) and finding solutions to challenges such as research coverage and comparability, asset class-specific considerations, portfolio manager integration capabilities, and portfolio manager reporting on integration efforts.

In order to summarize the information presented within this report, and in order to frame the discussion topics set forth, this chapter identifies key points and recommendations for implementing total fund ESG integration.

Policy

Policies often have dual objectives of being informative but also appropriately tempered. Stakeholders should not expect that policies spell out all specific RI activities in each asset class, or specifications for targeted engagement, for example. However, an RI policy should be useful for both internal and external stakeholders to gain understanding of the guidelines and objectives of the RI program. Furthermore, in order to promote accountability for implementing the RI program, the RI policy should discuss the role of RI and/or mainstream staff who are responsible for implementing the policy and monitoring this implementation.

The RI policy offers an opportunity to provide a unified statement of purpose for the RI program, as well as information on the components of the program and the methods for policy review and monitoring progress. However, in some cases where the RI policy is provided as a separate document, it can be difficult to determine how the RI policy impacts the larger investment program or how it relates to other policy documents.

It may be that some policy statements are a result of the evolution in RI, so that active ownership programs predate other ESG integration initiatives within the specific organization. However, the increased visibility of ESG integration and engagement provides new opportunities to consolidate the various statements of policy, definitions, etc. without necessarily providing more detail on implementation or goals. Particularly, if the relationship between RI and the Investment Policy Statement was made more explicit, these documents might send a stronger message to stakeholders regarding an organization's commitment to RI.

RI policy: A model for implementation

After reviewing publicly available examples and applying our own experience, we have outlined the following model for approaching RI policies. We suggest approaching RI and ESG integration policy as an extension of existing Investment Policy Statements.

A typical Investment Policy Statement may include several headings that provide stakeholders (members, consultants, managers, staff, etc.) with necessary information on the goals of the program, the various roles and responsibilities of staff, the mechanisms for achieving those goals, and the specific requirements of portfolio companies, external managers, and other parties. Below we provide a general Investment Policy Statement outline adapted for the communication of an RI policy:

1. Introduction and objectives: This section should include the rationale beyond the organization's involvement in RI. It should also include the policy statement and strategy. References to the PRI or other applicable standards or guidelines are appropriate here.
2. Roles and responsibilities: A description of defined assignments and positions is useful for those trying to implement the policy. Broad descriptions of the roles of internal staff and service providers are helpful at this stage.
3. Implementation across asset classes: The details of implementation may be in development and dynamic across asset classes, but a statement of the approaches which may be used to implement within each asset class would expected here. If applicable, lists of the most relevant issues, exclusions, and perhaps goals for ESG-targeted investments or ESG integrated assets. This would also be a good place to reference asset class or issue-specific policies such as corporate governance or voting policies and discuss approaches to engagement, as well as issue-specific or asset class-specific collaborative initiatives.
4. Evaluation, review and monitoring: This is an important statement to give credibility to the policy. Methods for reviewing the policy, tracking compliance and monitoring progress in implementing the policy should be described in this section. In addition, specific guidelines for the selection or evaluation of existing and prospective managers, consultants, and others should be included here.
5. Communication: This section gives investors an opportunity to lay out the structure of planned communications and reporting around RI. A list of forums or planned documents (PRI response, RI annual report, voting results, etc.) can be listed here.

In addition, to policy content, we believe it is important to comment on policy structure. In reviewing the publicly available information, we identified some elements of preferred structure that might help to clarify policies and improve efficiency in reporting and compliance.

1. Single document: One element of this structure that is essential is a single document that clearly spells out the overall RI policy and approaches. This could be modeled off the five sections described above. References to applicable commitments such as the PRI (or a statement that the PRI is the overall policy) would also be useful here.
2. References to additional policies: There may also be a need for a stand-alone governance or proxy policy, or for other relevant policies that address regulatory requirements. However, these should be clearly cross-referenced and various staff and service provider roles and responsibilities should be clarified in all policy documents where possible.
3. Relation to general Investment Policy Statement: Over time, one of the main goals of RI is to integrate ESG issues and active ownership into the general investment decision-making process. It follows logically that as the field develops, we will more frequently see references to RI in the organization’s Investment Policy Statement or vice versa. If that is not currently the case, it is still beneficial to communicate the link to the Investment Policy Statement in an RI policy statement so that it is clear to readers and stakeholders what role RI plays in the investment process and program.

Asset class-specific integration

Of the broad areas covered in this report, this is the one that has advanced the furthest in recent years, but also likely has the furthest to go. It will take substantial time and resources to reach the optimal combination of ESG integration, screening, active ownership and targeted investments for each asset class and for each organization. It is also within specific asset classes where the outcome for RI is intimately tied to trends in the broader institutional investment community. Going forward, ongoing debates regarding active vs. passive, internal vs. external and global equity management, the role of alternatives, and so on, will impact how RI policies are realized within various asset classes.

Conversely, there is also an opportunity to more strongly insert RI considerations into these broader debates, as ESG integration may, in turn, impact how the investment community views and shapes future options. Amid the many unanswered questions are opportunities for investors to facilitate the uptake of ESG integration in more specific ways across asset classes and to more heavily influence the more “tried and true” models for investment decision-making.

To date, collaboration on RI, at least as visible in the public domain, has focused on voting and engagement. In contrast, relatively few new investment vehicles have been seeded by institutions collaborating with ESG integration in mind. In order to catalyze innovation and be trend leaders, leading RI institutions must be willing to collaboratively participate in, or encourage, vehicle development. Similarly, asset owners or managers have either developed proprietary approaches on how best to integrate ESG factors, or have yet to develop these approaches to the point of discussing them publicly.

In shaping the industry to better achieve ESG integration, there are several areas where institutional investors can lead, such as to:

- Send the message to external managers that these issues are important by implementing specific monitoring and reporting mechanisms (collaboration can help here to pool experiences and discuss alternatives, or perhaps share responsibilities for common managers)
- Undertake or facilitate (internally or externally) qualitative and quantitative research on how integration works in practice, how to overcome challenges, and how to implement in challenging sub-asset classes (small cap, emerging markets)

In terms of new investments, investors might consider a co-investing consortium for ESG integration within private equity, infrastructure, or real estate investments. This may also speak to a need to continue to develop RI specialist knowledge in specific asset classes (or conversely, develop RI expertise within the pool of asset class specialists), which is no small task. Arguably, peer investors could cross leverage their internal resources more effectively to mutual gain, however, this would require thoughtful scoping and implementation structures to ensure desired outcomes.

Fixed income offers a particular challenge, as there does not seem to be much work done to date beyond the parallel application of screening criteria to fixed income credit and public equity. Given the characteristics of fixed income investing (mainly, the focus on avoiding defaults), screening based on serious ESG risks, to the extent that they can be extrapolated, can be a fair approach to ESG integration in this asset class. However, there are additional opportunities to address social or environmental issues through targeted “green” or community development bonds, which appear to have a growing market. Large institutions can continue to facilitate the growth of these markets by requesting such vehicles and participating in their issuance.

Within fixed income, there may be some overlap in terms of ESG exposure with instruments from other asset classes such as private equity and infrastructure. An institution may be able to get “bigger bang for its buck” through linking these opportunities and ESG criteria. Again, collaboration and discussion of shared experiences can help to move this type of activity forward.

In addition, institutions and RI programs may benefit from including fixed income in the governance/active ownership program. Though fixed income investments do not normally include voting rights, active owners may wish to link their holdings with equity holdings in order to increase the assets associated with a particular issuer. In this way, voting and engagement can be increasingly linked to the investment process in order to help determine when the last resort of divestment (at least from holdings in one asset class or the other) may be appropriate.

Voting and engagement capabilities are well developed among responsible investors and collaboration is increasing through the use of collaborative initiatives and engagement overlay providers, as well as other resources. However, further opportunities for engagement still exist. For example, a handful of institutions use a “focus list” approach to corporate governance and other types of advocacy; in this light, in may be possible for institutions to sign on to each others’ lists or create common criteria for a new, collaborative list. This approach is similar to existing collaborative initiatives, although investors would be able use criteria across multiple regions and issues, including investment performance. The high profile nature of peer organizations also promises to ensure such a global collaboration would be a high impact endeavor.

Asset class-specific integration: A model for implementation

The peers reviewed for this report represent a range of organizational structures, investment policies and asset allocations. It is difficult to prescribe a single approach to ESG integration across all asset classes, especially as ESG research and implementation in some asset classes is in such early stages. However, in reviewing leading practices and considering our own work in the field, we have identified some preferred steps that investors can take to continue along the road of ESG integration across all asset classes.

1. Implementation framework: Within the context of the RI policy and the associated goals, organizations should develop a framework for implementation that pays specific attention to organizational expertise, resources, timelines, asset allocation, performance targets and other factors. Ideally, this framework would be flexible enough to be consistently applied to each asset class, but detailed enough to cover the necessary bases of primary risks and opportunities associated with ESG in each asset class, the roles of internal staff and external service providers in each asset class, and the monitoring of progress in each asset class.
2. Oversight: Centralized responsibility (and authority), at least for creating the framework and completing associated training and implementation “modules” for each asset class, is likely necessary. This person or team will be charged with developing and rolling out the necessary supporting research and implementation plan to each asset class, ideally with asset class specialist participation and support, and also perhaps with monitoring and reporting on progress. Development of a centralized reporting framework for each asset class to track progress against policies and goals may also be relevant for many organizations and can help streamline responses to the PRI assessment or other surveys or inquiries.
3. Collaboration: This is a well-known tool among RI practitioners, but its importance continues to increase and develop. Investors are increasingly seeing the need for more research supporting ESG integration, especially as efforts expand to fixed income and alternative asset classes. Funding this research

collaboratively lends credibility and reduces the resources expended by any one investor. A similar case can be made for cooperating on the development and seeding of new ESG integrated and targeted investment products. If RI leaders see a gap in product offerings for specific types of strategies (for example, fixed income or issue-specific investments) they likely have, or have access to, the resources and the expertise to select a manager and to help create such a product. Moving forward, investors may also see collaboration expanding to areas such as strategic direct investments.

4. Engagement: This is another pillar of RI that is quite established within the RI community. There are opportunities, however, to expand the reach of this approach beyond public companies. Engagement activities have been initiated with external investment managers and consultants, but investors can do more in terms of RFP language, expectations of managers for reporting, and information provided to them to facilitate ESG integration. These can be time consuming and resource intensive activities but can help to move the industry along. RI industry dialogue has also recently increased between investors and index providers, credit agencies and governments, which has the potential for substantial impact over time.

Reporting

For most organizations reviewed for this report, RI reporting is in relatively early stages, since policies, commitments and approaches are still being developed. As assets within the RI space grow and the PRI enters its fifth year, expectations for public disclosure will increase. For this component of RI policy implementation, collaboration may be of limited use. But certainly discussions among peers or some support from the PRI secretariat, for example, for ongoing dialogue may be appropriate.

Based on progress made to-date, we believe that the institutional investor community is ready to absorb more quantitative measures of both implementation of ESG policies and investment results related to RI. There are many reasons why these disclosures are currently rare. For example, many ESG integration efforts are relatively new, making results in an industry that usually relies on a 3 year plus track record more difficult to disclose. Short track records also accentuate the impact of the recent recession. Furthermore, the industry is struggling with how to attribute ESG considerations to performance and the risk of portfolios where these considerations are applied. Still, to the extent that results are reportable, we believe there is demand for this information. As the industry grows, an increasing number of investors, investment managers, portfolio companies, journalists and students are seeking this type of information.

Reporting: A model for implementation

In reviewing publicly available information and reports on ESG integration and RI policy implementation we came across a variety of documents with a wide range of scope, length and frequency. This is understandable, given the differences in organizational structure, mission and position on the ESG integration continuum. Some organizations are entering their sixth year of reporting on RI efforts, while others are just beginning.

However, all organizations are still in the process of executing total fund ESG integration and so reporting is likely to continue to evolve. As we suggested integrating RI policies into the standard Investment Policy Statements, we also suggest looking at RI reporting through the lens of corporate sustainability reporting or annual investment reporting.

1. One comprehensive document: In the long run and as RI programs develop, creating one document describing RI activities across approaches and asset classes will be a more efficient approach than creating and updating separate documents. If implementation and reporting efforts are coordinated, then investors can apply the same “framework” to developing implementation modules for asset classes. This integrated framework can also be used to facilitate both internal and external reporting on progress by adding metrics or other items for public consumption. Once this information can be centrally collected, it can be sliced and diced in a number of ways depending on the purpose (Investment Committee reporting, public annual reporting, PRI assessment, etc.).
2. Balance between quantitative and qualitative information: Most current RI reports are decidedly qualitative, with quantitative aspects often limited to percentage of assets involved on ESG integration or ESG targeted investments. While these are important indicators, we believe the investment industry is anxious to see additional measures such as the performance or risk profiles of those assets, the use of ESG benchmarks, the costs of particular activities, and the future targets for implementation. Non-financial, quantitative indicators such as number of staff, training hours, number of RFPs with ESG requirements, number of managers reporting on ESG, voting records, engagements and others also have a significant role to play. At the same time, qualitative information is still very important, particularly as it is the most readily available and established. Case studies of successful engagements and descriptions of targeted investments will help round out the report and help communicate the impacts of RI activities.
3. Measuring ESG impact: Some organizations may have a desire or mandate to report on the environmental or social impacts of ESG integration in addition to the financial impacts. This type of reporting is in its early stages but we expect continued development. There is currently no standard across issues or investments, but some may be more straightforward than others. For example, reductions in emissions from sustainable timber, jobs created with an infrastructure project, or credit lent through microfinance may be provided by a portfolio manager or calculated by a consultant. However, quantitatively measuring the impact of sustainable investing in public equity for example or the impact of social policies within property may be more difficult to specify. As this process develops, it may be useful for investors to align these indicators with their RI policies. In other words, investors may be well served by focusing on issues, sectors or asset classes that, within their specific organization, are highest priority or are furthest along in implementation. This may also be an area where engagement with managers and research providers can help speed progress.

4. Developing a template: As with RI policy and ESG integration among asset classes, ideally, investors can create a format that suits their purposes but also offers flexibility so that they can incorporate new developments. For example, quantitative indicators may be added as implementation is rolled out in more detail for each asset class. Having a template that has room for these additions over time can save time in the long run and can make the template more effective for multiple uses, reports, and inquiries.
5. Industry standard for RI reporting: At this stage in RI's development we favor sharing and cooperation among reporting organizations rather than the formal development of an industry standard. Development of Key Performance Indicators for total fund ESG integration may be a helpful task, but anything further, while providing leadership, may deter organizations that are interested in reporting but lack resources. Perhaps the development of guidelines for reporting or key indicators of progress is something that that PRI could consider as a work stream.

Overall discussion

CalPERS and Mercer expect that this review of public information, presentation of suggested discussion topics, and resulting conclusion will be of use to CalPERS and the peers as they continue to discuss next steps for ESG integration. To the extent that there was still low hanging fruit for investors implementing the PRI, it is disappearing quickly, due to the hard work and commitment of many within the industry. That is to say, the bar is being raised. However, challenges still exist, including issues related to resourcing and staff, competing priorities, and regulatory barriers.

Meeting these challenges will be necessary in order to move the industry forward. To this end, this exercise – including this report, the questionnaire, the interviews and the October 6 workshop – is envisioned to help frame opportunities for working towards solutions.

To help shape discussions on October 6, Appendix A provides an inventory of the "Looking ahead" bullet items put forth in the sections of this report. We look forward to the outcomes, and to the promising emergence of RI's second decade.

Appendix A

Aggregation of "looking ahead" discussion topics

For reference, the following presents a list of the discussion topics presented throughout the report.

Policy

2.1 Regular review (every 1-2 years) of the RI policy in order to include evaluation of existing components and consideration of new issues, approaches and objectives

2.2 Asset class specific policies or guidelines that apply ongoing research regarding material ESG factors and outline expectations for portfolio managers and monitoring efforts (guidelines can be useful internal tools, since they are typically more flexible and applied in nature than policy documents)

2.3 Timelines or targets for ESG integration across asset classes and targeted ESG mandates (tracked by AUM-ESG or the development of new indicators such as ESG training hours, etc.)

2.4 Guidelines for engagement with existing and new external managers, including ESG specific language within RFPs and ESG-related monitoring and reporting requirements

Private equity

3.1 LPs engaging current GPs on ESG issues and encouraging GPs to integrate ESG factors into the due diligence process

3.2 LPs encouraging or requiring current GPs to report on ESG integration and incorporating it into their selection and monitoring processes

3.3 LPs seeding ESG-targeted private equity funds or fund managers

3.4 Collaborative industry efforts to improve the scale and capacity of ESG-related private equity investments, as well as metrics and standards for investment due diligence

3.5 ESG-targeted allocations beyond clean technology to other environmental and social ESG related sectors, as well as emerging markets

Property

3.6 Development of real estate specific RI policies

3.7 Extension of ESG issues beyond energy efficiency, resource efficiency and waste management, including labor conditions

3.8 Incorporation of ESG factors into the due diligence process for all real estate investments

3.9 Integration of ESG considerations into the management of direct property holdings

3.10 Requirement of LEED or other relevant certification for new development projects and for organizations' operational office buildings

3.11 Expansion of the range of investment vehicles available to responsible property investors through seed capital or engagement

3.12 ESG themed property-related investments such as green mortgages, affordable green housing bonds and energy efficiency funds (for example, financing energy efficiency retrofits and receiving the energy savings as returns, which could be a good opportunity for generating returns and providing catalyst funding)

Infrastructure

3.13 Increased industry collaboration as more investors consider ESG factors in their infrastructure investment decision-making processes

3.14 Increased collaboration of co-investors in order to promote ESG integration

3.15 Development of innovative ESG-themed infrastructure vehicles, perhaps including elements of other asset classes such as carbon finance

3.16 More research and case studies regarding social issues in infrastructure such as labor, human rights, health, etc.

3.17 Identification of innovative opportunities involving third party sponsors of infrastructure projects (such as the World Bank), and/or around specific themes (such as climate change adaptation)

Fixed income

3.18 Identification of opportunities for engagement in fixed income, particularly during the development of an issue

3.19 Collaboration with issuers and or with investment banks who underwrite issuers (resources and experience from engagement within other asset classes can inform these activities, and investors can consolidate their resources in cases where exposure to a company or ESG issue spans asset classes)

3.20 Identification of ESG-targeted fixed income opportunities spilling over from other asset classes' investments in microfinance, infrastructure, and carbon finance (the RI community and the institutional investment community more broadly are well poised to consider these investments as conversations around new risk management tools and asset allocation models continue)

3.21 Identification of opportunities in fixed income involving third party sponsors of infrastructure projects (such as the World Bank)

Public equity

3.22 Investor involvement in creating/seeding new products (investors may see a benefit to seeking ESG sector specific expertise outside their in-house RI teams and, in response, seed or collaborate in the development of new products/approaches)
3.23 Continued development of specific expectations for external managers as pension organizations develop their RI implementation strategies
3.24 Further discussion on how to measure and monitor ESG integration progress and use the data to improve both internal and external application of RI policies
3.25 Further discussion of methods for ensuring that RI specialists or research sources are being used throughout the organization
3.26 Discussion of how ESG integration practices apply to passively-managed equity mandates
3.27 Continued research into how ESG integration impacts risk management and equity portfolio performance attribution
3.28 Continued assessment of the role of ESG in overall public equity portfolios

Other investments

3.29 More research and case studies regarding ESG issues in commodity, derivative and hedge fund investing
3.30 Consideration of the governance structure of hedge funds themselves and how this relates to strategic asset allocation
3.31 Increased transparency around the use of derivatives across asset classes
3.32 Consideration of how derivative products can provide incentives for sustainability or promote good governance
3.33 Identification of innovative opportunities for hedge funds and commodity/derivative investors interested in making ESG-targeted investments
3.34 Increased industry collaboration regarding time horizons and speculation and impacts on financial markets

Reporting

4.1 Provision of information regarding RI or ESG-related policies and activities in a centralized location on the organization’s website – including links to applicable policy documents, guidelines and reports – for wide-spread internal use and external reference
4.2 Integration of information relating to RI and ESG factors into the public annual investment report
4.3 Provision of quantitative targets or goals for future implementation of the RI or ESG-related policies

4.4 Inclusion of measurements, metrics or benchmarking in public reporting to demonstrate the implementation and investment impact of the polices

Appendix B

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- The value of Gilts, bonds, and other fixed income investments including unit trusts can go down as well as up and you may not get back the amount you have invested.
- Investments denominated in a foreign currency will fluctuate with the value of the currency.
- The value of investments in real property can go down as well as up, and you may not get back the amount you have invested. Valuation is generally a matter of a valuer's opinion, rather than fact. It may be difficult or impossible to realize an investment because the property concerned may not be readily saleable.
- Certain investments, such as illiquid, leveraged or high-yield instruments or funds and securities issued by small capitalization and emerging market issuers, carry additional risks that should be considered before choosing an investment manager or making an investment decision.

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